CFC legislation in the European Union and the alternative CSC concept

Bader, R.G.

Publication date:
2012

Document Version
Publisher's PDF, also known as Version of record

CFC Legislation in the European Union and the Alternative CSC Concept

Robert Gebhard Bader

Thesis Tilburg University, the Netherlands

CFC Legislation in the European Union and the Alternative CSC Concept

Proefschrift ter verkrijging van de graad van doctor
aan Tilburg University,
op gezag van de rector magnificus,
prof.dr. Ph. Eijlander,
in het openbaar te verdedigen ten overstaan van een
door het college voor promoties aangewezen commissie
in zaal DZ1 van de Universiteit

op woensdag 30 mei 2012 om 16.15 uur

door

Robert Gebhard Bader
geboren op 25 december 1967 te Horb, Duitsland

Promotor:

Prof.dr. E.C.C.M. Kemmeren

Overige leden van de Promotiecommissie:

Prof.dr.dr.h.c. M. Lang
Prof.dr. E. Reimer
Prof.dr. P.H.J. Essers
Prof.dr. J.A.G. van der Geld

CFC Legislation in the European Union and the Alternative CSC Concept

Table of Contents

Part I - Introduction

1. Introduction

1.1. Motivation for the Study

Working in the field of international taxation, questions related to CFC legislation[1] are of great practical relevance. International investments and restructurings can become less attractive - or even unattractive - just because of the application of CFC regimes. This is not only true for the generation of typical “passive” income like interest and royalties, but also for the relocation of group operations to other states which may lead to “base company income.” It is therefore apparent that the application of CFC regimes can have a major impact on the international activities of a taxpayer. It is equally apparent, in my opinion, that it is unacceptable that the state of the shareholder taxes all of the income derived through a foreign entity on a current basis. One has to keep in mind that the income usually also encompasses elements of income which are produced in the CFC state or where the CFC takes over substantial risks. Moreover, in an EU context it is obvious, based on the case law of the European Court of Justice, that Member States cannot - at least not without justification - restrict the foreign activities of their residents. The outcome of the *Cadbury Schweppes* case clearly shows that this is also of great importance for the application of CFC regimes.

The fact that a number of Member States still follow the “typical” CFC regimes makes the research in the European context particularly interesting. This became already clear when I was working on my Master thesis at the European Tax College in Leuven, which was mainly focused on the comparison of European CFC regimes. From my perspective, it is obvious that the typical CFC regimes are “outdated” and not ready for an application in an internal market. The CFC regimes require alternatives which accept the (limited) necessity of an anti-deferral approach but which are, at the same time, acting within certain legal and economic parameters. With this PhD thesis I would like contribute to the ongoing discussion on the changes or even the abolition of CFC regimes and would like to provide an alternative concept to the existing regimes.

1.2. Definition of the Problem

One of the decisive questions in this context is the question whether the principle of capital import neutrality or the principle of capital export neutrality should be the prevailing principle in the taxation of foreign source income. If one comes to the conclusion that the principle of capital import neutrality should be the prevailing principle not only for the taxation of income from direct investments but also for income from portfolio investments, there is an obvious conflict with the excessive current taxation of income under most of the existing CFC regimes. The problem, though, is the fact that the OECD-MTC, as one of the most important international patterns for the conclusion of double tax conventions, is fostering the residence-based taxation of certain passive and base company income. Such an approach is therefore rather supporting the relocation of certain capital intensive activities to states and territories which provide for a lower taxation of income. Thus, the general

[1] The term “CFC” covers also the foreign investment fund (FIF) rules. However, in cases where it is important to make a distinction between CFC and FIF legislation, the rules are mentioned and described separately.

acceptance of the principle of capital import neutrality does not necessarily mean that there is no need for a “limited” taxation according to the principle of capital export neutrality. However, not all of the income components have to be treated identically, since not all of them have to be safeguarded from a competitiveness point of view. It is quite important, under the circumstances outlined above, to deviate from the existing transactional and entity based CFC regimes towards a new concept which is much more linked to the principle of capital import neutrality and the aim of fostering competitiveness. It is apparent, in my opinion, that this cannot be achieved by a mere horizontal separation of income, like in case of the transactional regimes, but requires, in addition, a vertical separation of income. In order to determine such a new concept, it is important to identify and to determine the economic and legal basis, the possibilities and limits from an EU law perspective and the basic requirements from an anti-avoidance point of view. It is also important to examine the various types and the specific elements of the existing CFC rules as well as the interrelation with double tax conventions.

1.3. Methodology

The study is divided into four parts. In Part I (Chapter 1 - Introduction) the motivation for the study, the definition of the problem and the methodology will be described.

Part II (Chapter 2 to 4 - General Aspects) will deal with economic principles in international taxation, legal principles in international taxation and EU law - always related to policy considerations and principles which are of importance in the context of this study and the application of CFC rules.

In Chapter 2 the general economic principles in international taxation, the capital export neutrality and the capital import neutrality will be described and examined with a view to direct investments, portfolio investments, investments in tangible and intangible property, and “hybrid” investments. It will be examined, from an economic perspective, to which extent a horizontal and vertical separation of income is necessary.

In Chapter 3 the legal principle of equity will be verified. Similar to the previous chapter, this will be made in relation to direct investments, portfolio investments, investments in tangible and intangible property, and “hybrid” investments. The horizontal and vertical separation of income will be examined from this angle as well. Moreover, some of the general aspects of the OECD-MTC will be outlined, such as the question of international juridical double taxation vs. international economic double taxation, the prevention of tax avoidance and tax evasion, and the allocation of taxing rights.

In Chapter 4 the basic freedoms which may be of importance for this study will be examined based on the case law of the European Court of Justice. This will encompass the scope of the freedom of establishment, the freedom to provide services and the free movement of capital. I will also deal with the simultaneous application of basic freedoms as well as the possible justifications under the rule of reason for restrictions of the latter freedoms. Moreover, the possible impact of the Parent-Subsidiary Directive will be examined in this context as well.

In Part III (Chapter 5 to 9 - CFC and FIF Legislation in the European Union and the Alternative CSC Concept) the general aspects of CFC and FIF legislation, the various types and the specific elements of European CFC and FIF legislation and the impact of double tax conventions will be verified. Further, the CFC legislation will be tested against EU law and, finally, an alternative concept will be presented.

In Chapter 5 I will outline the general aspects of the current taxation of income, the policy rationale of CFC legislation and the concept of deferral. I will describe the alleged alternative measures for CFC legislation and will go into detail of the ability-to-pay principle. I will further describe the differences and similarities to the taxation of permanent establishments and (transparent) partnerships. Finally, I will verify the OECD Report on Harmful Tax Competition and the EU Code of Conduct.

In Chapter 6 I will concentrate on the various types and the specific elements of European CFC and FIF legislation. The different types of transactional approach and entity approach regimes will be presented, compared and tested to the principles derived from previous chapters.

The interrelation between CFC rules and double tax conventions will be in the focus of Chapter 7. Here, I will deal with international case law and the OECD perspective. Furthermore, I will focus on the question how CFC income should be seen in the light of the OECD-MTC. The outcome of the examination will be again tested to the principles derived from previous chapters.

Chapter 8 will be focused on CFC legislation and Primary and Secondary EU law. The findings will be tested to the principles derived form previous chapters and the conclusions from the examination shall be the basis - from an EU law perspective - for an alternative concept.

In Chapter 9 I will develop and present a concept for an alternative to the existing CFC regimes. The concept shall be in line, as much as possible, with the conclusions derived from the previous chapters.

Part IV (Chapter 10 - Concluding Observations) concludes this study. The outcome will be summarised and conclusions will be drawn.

Part II - General Aspects

2. Economic Principles in International Taxation

2.1. Introduction

In general, tax systems can be divided into two main systems, the taxation of residents according to the principle of worldwide taxation[1] and the taxation based on the principle of territoriality.[2] Pursuant to the first principle, the principle of worldwide taxation, a state taxes the domestic and foreign income of its residents.[3] The system itself is based on the economic principle of capital export neutrality (CEN). Under the second principle, a state does not tax the foreign income of its residents but limits its taxing power to the income derived in its territory by residents and non-residents.[4] Such system is economically based on the principle of capital import neutrality (CIN). Both tax policies are in practice often applied parallel to each other and embedded in one uniform tax system, and certain varieties and deviations are possible. For example, pure territorial systems - which do not tax the foreign income of its residents at all - are rather uncommon.[5] It is often a partial territorial system which is applied and which exempts from tax some, but not all, of the foreign income of its residents. The importance of these two basic systems and the fact that they are based on two different economic principles makes it necessary to have a closer look at those underlying economic policies.

2.2. The Economic Principle of Capital Export Neutrality

2.2.1. Capital Export Neutrality

Pursuant to Peggy Musgrave, international tax neutrality toward investment may be defined as a situation in which the pattern of taxation does not interfere with or affect the taxpayer's choice between investing at home and investing in foreign countries.[6]

---

[1] A residence-based system of taxation.

[2] A source-based system of taxation.

[3] See, *inter alia*, Bühler, Prinzipien des Internationalen Steuerrechts, Amsterdam 1964, page 165; Engelschalk / Flick et al.., Steuern auf ausländische Einkünfte, München 1985; Schulze-Brachmann, Totalitäts- oder Territorialitätsprinzip, StuW 1964, page 589 et seq.; Vogel, Die Besteuerung von Auslandseinkünften, in: Vogel, Grundfragen des internationalen Steuerrechts, Köln 1985, page 3 et seq. (page 17 et seq.); Schindel / Atchabahian, Source and residence: new configuration of their principles, General Report, IFA 2005, pages 58 to 72.

[4] See, *inter alia*, Wassermeyer, Die beschränkte Steuerpflicht, in: Vogel, Grundfragen des internationalen Steuerrechts, Köln 1985, page 49 et seq.; Bellstedt, Die Besteuerung international verflochtener Gesellschaften, 3. Auflage Köln 1973, page 17 et seq.; Schindel / Atchabahian, Source and residence: new configuration of their principles, General Report, IFA 2005, pages 73 to 79.

[5] According to the IFA Report 2005, very few countries follow a pure territorial system. Within the group of countries that submitted branch reports to the 2005 IFA congress, it is only Uruguay (see Schindel / Atchabahian, Source and residence: new configuration of their principles, General Report, IFA 2005, pages 26 and 40). See also Figueroa who lists Bolivia, Costa Rica, El Salvador, Guatemala, Hong Kong, Kenya, Malaysia, Nicaragua, Panama, Paraguay, Singapore and Uruguay as the only countries that tax income exclusively on a source basis (Figueroa, Doble Tributación Internacional. Inmovilismo o Adecuación a la Nueva Realidad Mundial, X Congreso Tributario, CPCECABA, Buenos Aires (2003), cited in General Report, IFA 2005, page 40 (Footnote 58)).

[6] Peggy B. Musgrave, United States Taxation of Foreign Investment Income, Issues and Arguments (1969), page 109. See also Peggy Richman, Taxation of Foreign Investment Income, An Economic Analysis (1963) and Richard Musgrave, Criteria For Foreign Tax Credit, Taxation and Operations Abroad, Symposium (1960).

The idea is that without any public interference[7] capital will flow to the place where productivity is highest and therefore ensures efficiency in investment location decisions. This, in turn, has the effect of maximising global economic welfare (if the policy is not restricted to national neutrality). The centre of this economic principle is therefore the *concept of efficiency*. Export neutrality should in theory be achieved where the investor pays the same total tax[8] whether he receives a given investment income from foreign or from domestic sources.[9] Consequently, export neutrality implies a system of worldwide taxation plus foreign tax credit.[10] CEN requires that the same rules are applied to measure both foreign and domestic income, by allowing the same investment tax credits and accelerated depreciation for foreign investment and domestic investment.[11] It should be clear that the principle of capital export neutrality requires the current taxation of foreign source income received by an investor. The reason is very simple: the deviation from the principle of current taxation of foreign source income allows the deferral of such income which can have much the same effect as the exemption of income and therefore actually leads to a difference in taxation.[12] However, this is only of relevance in cases where the subsidiary is lower taxed. I will go into more detail on the question of deferral later on.

The principle of CEN and the way it is implemented in international taxation by way of taxing investment income according to the principle of worldwide taxation is far from being completely neutral. This can be illustrated by the following examples. Supposing an investor can earn a pre-tax return of 15 percent in its residence country A and the same pre-tax return in country B. In both cases an investment of 100 Euro results in a pre-tax return of 15 Euro. In the first alternative the residence country A applies a tax rate of 35 percent on the respective investment income and country B applies a tax rate of 20 percent. The after tax return of the investment in country A is therefore 9.75 percent.[13] The investment in country B yields in the same after-tax return since the investment income would be taxed in country A according to the same tax principles and the same tax rate would be applied to domestic and foreign income, i.e. the additional tax burden of 3 Euro in country B is to be credited against the 5.25 Euro of country A so that the total tax burden remains 5.25 Euro.[14] In this example, the investment decision would in general not be influenced by tax considerations and the allocation of capital would theoretically be efficient. That means if the pre-tax return in one of the two countries is higher than in the other, the

[7] This is, of course, not restricted to taxation. But tax policy is assessed isolated from a variety of other policies that might distort the location of investment. For example, protective tariffs, buy-national public procurement, and capital grants to firms can all tilt plant location decisions. Pursuant to the CEN school, these other policies should be corrected on their own turf (see Hufbauer, assisted by Joanna M. van Rooij, U.S. Taxation of International Income, Blueprint For Reform, Institute For International Economics (1992), pages 49, 50).

[8] That means domestic plus foreign tax.

[9] Peggy B. Musgrave, United States Taxation of Foreign Investment Income, Issues and Arguments (1969), pages 109, 110.

[10] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (311).

[11] Hufbauer, assisted by Joanna M. van Rooij, U.S. Taxation of International Income, Blueprint For Reform, Institute For International Economics (1992), page 50.

[12] See in this respect also Hufbauer, assisted by Joanna M. van Rooij, U.S. Taxation of International Income, Blueprint For Reform, Institute For International Economics (1992), page 57; Altshuler, Recent Developments in the Debate on Deferral, Tax Notes, April 2000, page 255 et seq. (258).

[13] 15 Euro pre-tax result minus 5.25 Euro tax (35 percent) = 9.75 Euro.

[14] Country B receives a tax of 3 Euro (20 percent) and country A receives a tax of 2.25 Euro (5.25 Euro minus 3 Euro tax credit).

capital would be invested in the country with the higher pre-tax return since the taxes on the investment income will not play any role in the decision.

In the following, the example can be amended by exchanging the tax rates of country A and country B, i.e. the tax rate of country A would be 20 percent and the tax rate of country B 35 percent. The result is basically similar to the example above if the tax system of country A allows a reimbursement of the excess tax credit. This would mean that country A taxes the income of 15 Euro with 3 Euro (20 percent) and has to give a foreign tax credit (or a reimbursement) of 5.25 Euro (35 percent) if the investor decides to invest in country B. Overall, country A will end up with a negative amount of 2.25 Euro and country B with a positive amount of 5.25 Euro. This is the consequent application of the CEN principle and would therefore place the investor in a situation which is similar to what was outlined above in the first example. It is obvious that tax jurisdictions are often not willing to follow a tax policy which provides for such excess foreign tax credit or a refund of such taxes.[15] Of course, this is due to revenue concerns which often take precedence over efficiency aspects. Moreover, there could be a strong temptation for country B to tax investments made by investors from country A more heavily since the extra burden would have to be borne by the tax administration of country A and not by the investor itself.[16] However, without a full credit for taxes paid to the source country B the investor resident in country A will be influenced by tax considerations. If the pre-tax return of the investment in country A and country B is the same the investor has a strong incentive to invest in his home country and would be reluctant to invest in a country with a higher tax burden. From an efficiency perspective, too little capital will end up in high tax country B.[17]

Pursuant to the proponents of the CEN principle, the allocation of capital across countries will not be distorted by the system described in the examples above provided that a full tax credit exists. However, in a model outlined by Rosanne Altshuler investors had to make two decisions: (1) how much to save and (2) how to allocate these savings across locations.[18] The underlying model considers two countries (A and B) with different tax rates. The tax rate in country A is higher than the tax rate in country B. Pursuant to Altshuler, the savings decision will be influenced by the different tax rates. The residents of the country with the lower tax

[15] See also Schindel / Atchabahian, Source and residence: new configuration of their principles, General Report, IFA 2005, pages 41, 42. There are, of course, exceptions to this approach. For example, the Directive on taxation of savings income in the form of interest payments provides for an excess credit of withholding tax deducted by Belgium, Luxembourg and Austria. Those Member States will introduce a system of information reporting at the end of a transitional period, during which they will levy a withholding tax at a rate of 15 percent for the first three years, 20 percent for the following three years, and 35 percent thereafter. 75 percent of the withholding tax will be transferred to the residence state of the investor. In turn, the residence state of the investor is obliged to credit the withholding tax deducted in those Member States and to provide for a reimbursement of an excess credit (see Council Directive 2003/48/EC of June 3, 2003, and Council Decision 2004/587/EC of July 19, 2004).

[16] Hufbauer, assisted by Joanna M. van Rooij, U.S. Taxation of International Income, Blueprint For Reform, Institute For International Economics (1992), page 52. It has to be added that the additional tax burden is not to be borne directly by the investor but only - to a lesser degree - indirectly. This would encourage the investment in country B since the higher taxation should have some impact on the infrastructure etc. in country B. See also Frisch, The Economics of International Tax Policy: Some Old and New Approaches, Tax Notes International, April 30, 1990, pages 18-49.

[17] See in this respect also Hufbauer, assisted by Joanna M. van Rooij, U.S. Taxation of International Income, Blueprint For Reform, Institute For International Economics (1992), page 52.

[18] Altshuler, Recent Developments in the Debate on Deferral, Tax Notes, April 2000, page 255 et seq. (257, 258).

rate (country B) receive a higher after-tax return on their savings than the investors resident in the country with the higher tax rate (country A). As a result, the residents of the latter country save too little, while those in the country with lower taxation save too much. The savings decisions are therefore distorted and welfare would be increased if returns from savings were transferred from the low-tax country to the high-tax country. Even though the capital allocation as such is not distorted, the system will not be neutral if the savings decision is taken into consideration.[19] In other words, the different tax rates in country A and B lead to distortions even if both countries apply a residence-based taxation.

Moreover, it should be clear that even if the effect of the savings decision is put aside, neutrality requires - in my opinion - that the residence-based taxation is generally applied to all existing relationships of the respective states. Any deviation from the principle of CEN and the residence-based taxation should consequently lead to non-neutrality. The same is true for other distorting factors apart from taxation.[20] A system can only be "neutral" or "non-neutral," i.e. if a distorting factor exists, the system will be non-neutral - even where the taxation follows the principle of worldwide taxation. I will go into more detail below.

2.2.2. National Neutrality

In contrast to the aim of enhancing worldwide efficiency and therefore maximising global welfare, the supporters of the principle of national neutrality focus on maximising national welfare. In the 21st century with an ongoing economic globalisation it seems to me that the principle of national neutrality cannot seriously be considered to be an alternative to inter-national neutrality. From a tax policy point of view, a country following the principle of national neutrality does not credit a foreign tax paid on the respective income but rather allows the deduction from the domestic tax base. This has the effect that the foreign tax is treated in the same way as other business expenses. In the aforementioned first example with a tax rate of 35 percent in country A and 20 percent in country B and a return of investment of 15 Euro the outcome would be as follows: country A, applying the principle of national neutrality, taxes an amount of 12 Euro[21] which results in a tax of 4.20 Euro.[22] The

---

[19] Altshuler, Recent Developments in the Debate on Deferral, Tax Notes, April 2000, page 255 et seq. (257, 258).

[20] Pursuant to Hubbard, *"(t)he theoretical model in which capital export neutrality results in worldwide efficiency in the allocation of capital resources is a fairly simple model. In its simplest form, savings in every country is in fixed supply and is not responsive to market opportunities. As a result, each dollar of foreign direct investment by a domestic resident results in one less dollar of domestic investment. The model makes a number of simplifications, but, even so, capital export neutrality leads to worldwide efficiency only if all countries follow a tax system imposing capital export neutrality. As noted earlier, in practice a substantial number of major trading partners of the United States (...) exempt active foreign source income from taxation. In such a case, an attempt by the United States to maintain capital export neutrality does not necessarily improve either worldwide efficiency or U.S. well-being. A well-know economic theorem shows that when there is more than one departure from economic efficiency, correcting only one of them may not be an improvement. Unilateral imposition of capital export neutrality by the United States may fail to advance both worldwide efficiency and U.S. well-being* (see the Statement of R. Glenn Hubbard, Testimony Before the House Committee on Ways and Means, Hearing on Impact of U.S. Tax Rules on International Competitiveness, June 30, 1999). The economic theorem mentioned by Hubbard is the general theorem in the theory of second best. The general theorem for the second best optimum states that if a constraint which prevents the attainment of one of the Paretian conditions is introduced into a general equilibrium system, the other Paretian conditions, although still attainable, are, in general, no longer desirable (Lipsey / Lancaster, The General Theory of Second Best, 1956, Review of Economic Studies, pages 11-32).

[21] 15 Euro minus 3 Euro additional business expenses (20 percent tax in country B).

after-tax return of the investment in country B for the resident of country A is therefore 7.8 Euro, whereas the investment in country A would lead to an after-tax return of 9.75 Euro.[23] Or from another perspective: the investment in country B must lead to a pre-tax return of 18.75 Euro (compared to 15 Euro in country A) in order to end up with the same after-tax result of 9.75 Euro.[24] Of course, in such a system there is a strong incentive to invest in the residence country. Only in cases where the foreign investment yields relatively higher - depending on the tax rate of the foreign source country - the resident investor would be willing to invest abroad.[25] This distortion of the location decision is basically inherent. Such a policy ignores the fact that other countries - which are affected by such tax policy - would be likely to react and change their own policies, with the effect that all countries (including country A) would experience a loss in economic welfare.[26]

Economic efficiency is, without any doubt to me, an aim which should be pursued on a global scale and not on a national scale, i.e. with the aim of maximising global welfare. However, it is obvious to me that in practice the aim of neutrality is difficult - if not impossible - to achieve.[27]

2.3. The Economic Principle of Capital Import Neutrality

The basic reasoning behind the principle of capital import neutrality (CIN) is *competitiveness*. Import neutrality means that capital funds originating from various countries should compete at equal terms in the capital market of any country.[28] A company resident in a high-tax country which expands its business activities to a low-tax country would have a real competitive disadvantage if the income received from these activities were taxed at the rate of the residence country. The reason is quite simple and can be illustrated by an example: If a resident company of country A (with a tax rate of 35 percent) expands its business activities to country B (with a tax rate of 20 percent) by incorporating a subsidiary or by creating a permanent establishment, the resident company of country A will have to compete with local firms and subsidiaries of multinational companies situated in other (third) countries. Supposing the foreign investment is taxed according to the principle of worldwide

[22] 35 percent tax of the tax base of 12 Euro.
[23] 15 Euro minus 5.25 Euro tax (35 percent tax in country A).
[24] 18.75 Euro minus 3.75 Euro additional business expenses (20 percent tax in country B) lead to a tax base of 15 Euro in country A and therefore to an after-tax result of 9.75 Euro.
[25] The increase in the return on investment corresponds to the tax rate of the foreign source country.
[26] Frisch, The Economics of International Tax Policy: Some Old and New Approaches, Tax Notes International, April 30, 1990, pages 18-49; Hufbauer, assisted by Joanna M. van Rooij, U.S. Taxation of International Income, Blueprint For Reform, Institute For International Economics (1992), page 57. Both, Frisch and Hufbauer, call it a "beggar-thy-neighbor" policy and according to Frisch the "rejection of national neutrality as part of a formal or informal cooperative outcome is likely to be the best way to maximize the U.S.'s economic interests." Thomas Horst considered three categories: "capital-export neutrality", "capital-import neutrality" and "international double taxation." The latter occurs "when both countries tax international investment income at the same rate as domestic investment income, but one country (e.g. the capital exporting country) allows a *deduction* for taxes paid to the other government." (see Thomas Horst, A Note on the Optimal Taxation of International Investment Income, The Quarterly Journal of Economics, Vol. 94, No. 4 (June 1980), pages 793-798 (794). According to Lehner, national neutrality can now be considered to a large extent meaningless ("*mittlerweile weitgehend bedeutungslose National neutrality*"), (see Lehner, Wettbewerb der Steuersysteme im Spiegel europäischer und US-amerikanischer Steuerpolitik, StuW 2/1998, page 159 et seq. (165).
[27] However, any departure from neutrality is consequently called "non-neutrality."
[28] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (311); Richard Musgrave, Criteria For Foreign Tax Credit, Taxation and Operations Abroad, Symposium (1960).

taxation,[29] a pre-tax profit of 100 Euro would be taxed in country A with a credit for the taxes paid in country B. This results in a total tax burden of 35 Euro (20 Euro tax in country B and an additional tax of 15 Euro in country A). In comparison to the local firms in country B and the subsidiaries of multinational companies resident in third countries which do not tax foreign investment according to the principle of worldwide taxation, the investment made by the resident company of country A has a competitive disadvantage of 15 Euro which equals 15 percent of the taxable profits. Or from another perspective: the investor resident in country A with business activities in country B has to earn a pre-tax profit of more than 123 Euro in order to end up with the same after tax result of 80 Euro.[30] The tax burden can basically be seen as an additional cost factor of the business activity in country B. But in contrast to his competitors the additional tax burden is only levied on the profits of the investor of country A. The investor will therefore not be able to reduce the "business expenses" in the same way as other competitors can do and will therefore suffer a considerable disadvantage. Any measures directed to improve the efficiency of the business activities will be less effective - compared to similar measures carried out by his competitors. This is especially problematic where the investor does not use the infrastructure of country A in order to carry out the business in country B and consequently does not receive any corresponding advantage for the additional tax burden which could - at least partly - improve his position.[31] The lower profit has the effect that the company is less attractive for (potential) investors and will therefore have negative consequences regarding the valuation of the company. Moreover, the "tax gap" cannot be used to finance new investments which would then have to be refinanced - more costly - by external financial means.[32]

Looking at this simplified example, one is tempted to agree in general with the position of the CIN proponents. However, the question is more complicated and complex and the type of activity has to be verified in more detail.

2.4. Capital Export Neutrality vs. Capital Import Neutrality

Whether CEN or CIN should be the underlying economic principle for taxing foreign source income can be restricted to a large extent to the question of whether the *concept of efficiency* should prevail over the *argument of competitiveness*, or vice versa.[33] However, since it is obvious that complete neutrality cannot be achieved, the question arises whether one should give preference to a system which in practice cannot lead to an efficient allocation of factors, and which will therefore always be

[29] Under the assumption that no deferral is possible for the investment made via a subsidiary in country B.
[30] A taxable profit of 123.08 Euro would trigger a tax of 43.08 Euro (35 percent) in country A and a tax of 24.62 Euro (20 percent) in country B - which can be credited against the tax of country A. The after-tax result would be 80 Euro. A local firm would be able to achieve the same after tax result with a pre-tax profit of 100 Euro.
[31] Under the assumption that the level of taxation corresponds to the degree to which public goods are provided (see Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (312); Gandenberger, Kapitalexportneutralität *versus* Kapitalimportneutralität, 7 Aufsätze zur Wirtschaftspolitik, Forschungsinstitut für Wirtschaftspolitik an der Universität Mainz (1983)).
[32] See in this respect also Gandenberger, Kapitalexportneutralität *versus* Kapitalimportneutralität, 7 Aufsätze zur Wirtschaftspolitik, Forschungsinstitut für Wirtschaftspolitik an der Universität Mainz (1983), page 12.
[33] See - for example - The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Report and Analysis, National Foreign Trade Council, Washington (December 15, 2001), page 5: „*Because the principles of neutrality and competitiveness conflict in a world where countries have unequal tax rates, policymakers must strike a balance between these principles.*" See with respect to competitiveness also Sanden, Taxing Foreign Source Income: A Businessman's View, New York Tax Foundation, 1977; Stanley S. Surrey, Current Issues in the Taxation of Corporate Foreign Investment, 1956, Columbia Law Review, pages 850-853.

"non-neutral."[34] Even if one agrees with the argument that tax policy should be assessed isolated from other policies that might distort the location of investment and that these distortions should be corrected on their own turf,[35] it cannot be ignored that a tax policy which follows the principle of worldwide taxation cannot be efficient if other distorting policies exist. Even if in such a situation the capital allocation were not be distorted by the tax system,[36] it would be distorted by several other factors. A tax policy which is directed at fostering efficiency but which remains basically unsuccessful can have particular negative consequences if the tax policy has, at the same time, the effect of hampering competition of resident companies which pursue activities in foreign markets.[37]

Moreover, it should be clear that any state with a low-tax system, or just a tax system with a lower taxation than in the residence state, will attract capital (and therefore the exercising of functions and the taking over of risks). Even if an international company refrains from investing in this particular state because of a residence-based taxation in the state of the headquarter company, the low-tax state will attract capital from other countries, especially from countries which provide for an exemption of the low-taxed foreign income. Companies from those countries will step in and create the functions which could not be relocated by the companies with residence-based taxation. At the end, the international company will either refrain from investing in the foreign country completely and will exercise the functions in the headquarter country – with a competitive disadvantage – or will use the services provided by the companies which stepped in. If the international company chose the second option, there would not be an efficient allocation of capital but a distortion of competitiveness. The choice for the second option will only be made where the outsourcing of the respective functions (and risks) is in total more advantageous for the international company in comparison to the exercising of the functions by the headquarter company. This could be the case where the payments for the third party services are below the comparable costs including the appropriate risk premium for the respective functions. It is therefore not only the difference in direct expenses which can be derived directly from the profit and loss account but also the risks connected to those functions. Even if the third party payments are slightly higher than the comparable expenses, an outsourcing can be more attractive where the difference does not adequately cover the risk connected to those functions. This is especially true for functions which can be easily separated.

Therefore, the tax rate can indirectly still be the decisive factor. But in comparison to the direct investment, the international company would have a disadvantage compared to those competitors who can directly take advantage of the lower taxation,

[34] See Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (313): „*It is, so I understand, the basic idea of neutrality that taxes should be imposed in such a way that economic processes continue to operate as if no taxes at all were levied (or more realistically, that they are distorted as little as possible). If this understanding is correct, I cannot see how the concept could be divided. Neutrality applied only to certain economic processes, to a selection out of the totality, like capital export or import, would always be less than full neutrality; it would be non-neutral."* See also Vogel, Which Method Should the European Community Adopt for the Avoidance of Double Taxation?, IBFD Bulletin 2002, page 4 et seq. (5): *"If neutrality means the absence of all (or nearly all) external influences, the absence of certain influences only, while other influences are upheld, is no neutrality."*

[35] See in this respect Hufbauer, assisted by Joanna M. van Rooij, U.S. Taxation of International Income, Blueprint For Reform, Institute For International Economics (1992), pages 49, 50.

[36] With respect to the savings decision see above.

[37] See also The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Report and Analysis, National Foreign Trade Council, Washington, D.C.,(December 15, 2001), pages 12-14.

i.e. who are currently not taxed according to a residence-based taxation. Thus, in a world where tax rates differ considerably from country to country a residence-based taxation cannot be expected to lead to an efficient allocation of capital. Especially where the difference in tax rates is high, it can be assumed that the tax advantage will find its way - directly or indirectly - to a potential investor.

On the other hand, even though the principle of CIN fosters competitiveness it is not self-evident that this is equally relevant for all kinds of investment in the foreign market. It is therefore necessary to have a closer look at the argument of competitiveness and to verify foreign direct investments separately from foreign portfolio investments and other types of investment.

2.4.1. Direct Investments

As already outlined above, the argument of competitiveness plays a significant role in the context of foreign direct investments. Foreign direct investment is considered to be an entrepreneurial activity in another country which is not only temporary or just a transient activity. Mere sales activities or the provision of services without a transfer of capital factors with a certain duration cannot be considered a direct investment in the foreign country. In such a case the foreign country simply provides a market for carrying out the activities but it does not lead to a capital transfer.[38] The legal form of the investment is not decisive, i.e. it can be an entrepreneurial activity in the form of a legal entity (subsidiary) or a branch (which is then typically described to be a permanent establishment).

It seems to be clear that such foreign direct investment can only be successful in the foreign market if the cost structure - including taxes - is comparable to those of the local competitors, irrespective whether the competitors are local firms or subsidiaries and permanent establishments of other multinational companies headquartered elsewhere. Any deviation from the comparable cost structure which does not result in a corresponding advantage affects the competitiveness of the investing company in the respective market. Taxes which are levied by the residence country of the parent company based on the profits of the foreign subsidiary or permanent establishment are typically not compensated by a corresponding advantage since the subsidiary or permanent establishment (in a typical case) does not take advantage of the infrastructure or other possible benefits of the parent companies residence country. If it is true that the level of taxation in any country is likely to correspond to the degree to which public goods and services are provided,[39] the parent company – together with the subsidiary or permanent establishment – will theoretically pay (indirectly) for goods and services which were never provided. It is therefore rather obvious that

[38] See in this respect Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (315).

[39] See in this respect Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (312); Gandenberger, Kapitalexportneutralität *versus* Kapitalimportneutralität, 7 Aufsätze zur Wirtschaftspolitik, Forschungsinstitut für Wirtschaftspolitik an der Universität Mainz (1983). Even though there probably always exists - at least to a certain degree - an "unproductive" or "wasteful" spending which can lead to an imbalance of taxes and corresponding public goods and services (see for possibilities to measure the "wasteful" spending in the Global Competitiveness Report (2003) of the World Economic Forum, Chapter 1.1., The Growth Competitiveness Index: Analyzing Key Underpinnings of Sustained Economic Growth, page 6 et seq.).

taxes should be paid according to the principles and the tax rates of the source country and not the residence country.[40]

The distortion which is caused by the additional domestic tax burden of the parent company (or headquarter) on the foreign source income has to be compensated in one way or another. That means the parent company (or headquarter) has to level out a disadvantage which is clearly allocable to the foreign investment and which is therefore a competitive disadvantage for the activities in the respective foreign market. Whether the company is able to compensate the permanent disadvantage caused by the immediate taxation or not is a completely different question. In order to end up with the same after-tax result of the foreign investment, the company in theory has to be more successful in the respective foreign market or to accept a lower after-tax result. However, the latter would immediately result in additional competitive distortions since the "profit gap" cannot be used for further investments and leads consequently to a lower valuation of the activities (and therefore of the company itself).

In a study[41] of the U.S. Treasury published in the year 2000 it was concluded that multinational competitiveness,[42] i.e. the ability of U.S.-owned multinationals to compete with foreign-owned multinationals, is an amalgam of many factors, only a few of which relate to taxes. The U.S. Treasury cited the global survey of the Institute for Management Development of the year 2000 which studied 290 separate factors, 14 of which related to taxes.[43] The U.S. Treasury pointed out that it was questionable whether any single feature of a tax system is likely to have a significant effect on multinational competitiveness.[44] Of course, competitiveness is influenced by a great number of factors, but in my opinion taxation is not a minor factor in this respect. In its Executive Opinion Survey (2003) of the World Economic Forum executives were

[40] See in this respect also The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Report and Analysis, National Foreign Trade Council, Washington (December 15, 2001), page 12: "*While the competitive impact of a heavier corporate tax burden is difficult to quantify, it should be clear that a company that pays higher taxes suffers a disadvantage vis-a-vis its more lightly taxed competitors. That disadvantage may ultimately take the form of a decreased ability to engage in price competition, or to invest funds in the research and capital investment needed to build future profitability, or in the ability to raise capital by offering an attractive after-tax rate of return on investment.*"

[41] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury (December 2000).

[42] The U.S. Treasury differentiates between trade competitiveness, standard of living competitiveness, and multinational competitiveness. The latter measures competitiveness by examining the ability of U.S. firms headquartered in the United States with production facilities abroad to compete in foreign markets with residents of the host country and other multinational firms based elsewhere (see The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury (December 2000), page 55; Staff of the Joint Committee on Taxation, Factors Affecting the International Competitiveness of the United States, Scheduled for Hearings before the Committee on Ways and Means on June 4-6 and 18-20 and July 16-18, 1991, 7-8 (1991).

[43] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury (December 2000), page 56; International Institute for Management Development (IMD), 2000 World Competitiveness Yearbook. In its 2004 Yearbook IMD defined even 323 criteria to measure competitiveness. The rankings of competitiveness criteria was as follows: economic performance (83 criteria), government efficiency (77 criteria), business efficiency (69 criteria), and infrastructure (94 criteria).

[44] The Deferral of Income Earned Through U.S. Controlled Foreign Corporations, A Policy Study, Office of Tax Policy, Department of the Treasury (December 2000), page 56.

asked to select the five most problematic factors - from a list of 14 factors[45] - for doing business in their country and to rank them. Respondents of the top-four ranking countries of the Growth Competitiveness Index[46] considered tax rates or tax regulations to be by far the most problematic factors for doing business.[47] Surely, in lower ranking countries other problems gain more significance, but it shows that in a highly competitive environment taxation is considered to be of great importance.[48]

Moreover, there is one very important distinction which has to be made between the *argument of competitiveness* and the *concept of efficiency*. The distortion caused by the current taxation of foreign source income will *always* have a negative effect on competitiveness. The company is always forced to balance out the negative impact caused by the immediate (additional) taxation. Even if the company is able to compensate the impact completely, it will still hamper the activities since it will lead to a lower after-tax result (even for the most successful companies the additional taxation remains a kind of "cost factor"). On the other hand, the efficient allocation of capital is distorted by several other factors and the investor will take all distorting effects into consideration in his decision where to invest. Even in an unrealistic case where the tax policy will not cause any distortion, it will be caused by other policies and the capital will flow to the place where it is most advantageous for the investor (which will not necessarily be the most productive place). The result of all distorting factors will be decisive and not each of the separate factors by itself. In a world of globalisation and a world of different tax rates and tax systems it seems to me that the creation of an environment which fosters competitiveness, i.e. a tax policy which allows companies to compete on equal terms in a respective market, would probably be the best and most realistic way to maximise global welfare. In other words: in a world where complete neutrality cannot be achieved the aim should be to foster competitiveness.

This can be done - and is most often done - by exempting the profit of a foreign permanent establishment from taxation in the headquarter country and by allowing the deferral of income of a foreign subsidiary, which can basically have the effect of an exemption of the residence country taxation. Irrespective of the way how the residence country taxes a subsequent profit distribution, it is - from the perspective of competitiveness - important to open the possibility for the re-investment of funds which are taxed on the level of the subsidiary in the same way as other local firms

[45] The 14 factors were tax rates, tax regulations, restrictive labour regulations, inefficient bureaucracy, access to financing, poor work ethic, policy instability, inadequately educated workforce, foreign currency regulations, inadequate infrastructure, inflation, crime and theft, corruption, government instability/coups.

[46] Order of the Growth Competitiveness Index rankings (2003 top-four ranking countries): Finland (1), the United States (2), Sweden (3), Denmark (4) (Source: World Economic Forum).

[47] The respondents in the top-ranking country Finland considered tax rates with more than 30 percent of responses to be the most problematic factor for doing business, followed by restrictive labour regulations (2), tax regulations (3), inefficient bureaucracy (4) and access to financing (5). In the United States, tax regulations were considered to be the most problematic factor, directly followed by inefficient bureaucracy (2), restrictive labour regulations (3), tax rates (4) and policy instability (5). In Sweden, tax rates (1) and tax regulations (2) together accounted for more than 40 percent of the responses, followed by restrictive labour regulations (3), inefficient bureaucracy (4), access to financing (5) and policy instability (6). In Denmark, tax rates (1) and tax regulations (2) accounted together for significantly more than 50 percent of the responses and were therefore considered clearly to be the most problematic factors for doing business. They were followed by access to financing (3), inadequately educated workforce (4), restrictive labour regulations (5) and inefficient bureaucracy (6) (Source: World Economic Forum, Executive Opinion Survey (2003)).

[48] In Taiwan (no. 5) policy instability and government instability are considered the most problematic factors for doing business.

and subsidiaries of multinational companies located elsewhere. Deferral is therefore commonly used and recognised as a way to foster competitiveness. The result is the elimination of the (potential) additional tax burden - at least in the first step[49] - and to create equal conditions from a tax point of view. In such an environment the improvement of competitiveness is no longer hampered by differences in taxation between the country of source and the country of residence.

2.4.2. Portfolio Investments

Foreign portfolio investment is an investment which is made without establishing an enterprise. Such an investment can be made by granting a loan to a foreign company or by acquiring a share of equity capital in a foreign company.[50] The portfolio investor does not benefit directly from the public goods and services supplied by the country in which the investment was made but only indirectly through the payment of portfolio dividends and the interest receipts. In case of a portfolio loan it is important to consider the position of the debtor, since the debtor - in the same way as the subsidiary and the permanent establishment outlined above - has to compete on the foreign market, is the direct recipient of public goods and services, and has to pay taxes according to the level of the foreign country. Neutrality with respect to a portfolio loan can therefore only be achieved if taxation does not change the market conditions subject to which the debtor's enterprise operates.[51] However, the market conditions can in theory be influenced by the taxes imposed on the interest income received by the creditor in the residence country. For example, this could be the case where the great majority of capital exporting countries imposes a higher tax on the interest income received by the portfolio investors (i.e. where the portfolio investors are taxed according to the principle of worldwide taxation). The part of the tax increase which could theoretically be shifted to the debtor[52] by increasing the interest rates depends first of all on the functioning of the capital markets. If there is a sufficient number of investors available (from other - lower taxed - countries) which step in when the high tax investors step out (or as soon as the interest rates start to increase), nothing or only a small part of the tax increase will be shifted to the debtor. If this is not the case, i.e. where the majority of investors is affected by the tax increase, a substantial part of the tax increase will have to be borne by the debtor. Since the creditor states are often high tax countries which apply a system of residence-based taxation, it can be assumed that a considerable part of the tax on portfolio interest is passed on to the debtor.[53] Pursuant to Vogel, the shifting will be even more important to the extent to which interest includes a premium for an unusual risk in certain countries.[54] Since the investor will only invest in the particular country if the additional risk is compensated by the risk premium, this requires

[49] Depending on the respective tax system the subsequent distribution can be taxable in the residence state of the shareholder. This will be discussed later on in more detail.

[50] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (315). According to Vogel the better term would be "non-entrepreneurial investment."

[51] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (316); Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 79.

[52] In order to receive the same after-tax return before and after the tax increase.

[53] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (316); Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 79.

[54] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (316).

theoretically that the tax on the risk premium is passed on to the debtor (or at least most of the tax). If this is not possible, the investor will choose an alternative investment where the after-tax risk premium is fully equivalent to the additional risk or where it is almost a full net-compensation.[55] The residence-based taxation of portfolio interest income can therefore not be considered neutral where the tax on risk premiums is shifted to the debtor and where the capital markets are dominated by high tax countries. It could be neutral where the residence-based taxation is limited to a risk-free yield, i.e. where the risk premium is not included in the tax base, and where at the same time sufficient loan capital is available from countries which do not tax on a worldwide basis.[56]

However, this does not necessarily mean that a source-based taxation is without any influence on the market conditions of the debtor. One should be aware of the fact that portfolio investments are to a significant extent made by institutional investors which are often subject to special tax treatment in their residence country, e.g. pension funds and life insurance companies. It is not the insurance company as such which is treated differently but the receipts of the special business property held by the insurance companies and which is related to – for example - life assurance contracts. Another important group are companies with tax loss carry forwards. This can be an especially important factor in economically difficult times. All of these investors would prefer a residence-based taxation since the income is either exempt from taxation, lower taxed, or – in the latter case – can be offset against an existing tax loss carry forward.[57] This has a much greater effect on portfolio investments compared to direct investments. The latter investments are typically based on entrepreneurial and strategic decisions with a certain permanence. However, an investment company would replace a publicly listed corporate bond immediately if – for whatever reason – the investment became unfavourable compared to a corporate bond of another company with a comparable rating in another country. For example, if certain corporate bonds in country A - within a certain rating category - yield an interest rate of 7 percent and country A decides to introduce a tax of 25 percent on interest income of foreigners, this would have an immediate effect on the aforementioned investors. Those investors would only invest in corporate bonds in country A if the interest rate went up to 9.33 percent, which would then lead to an after-tax return of 7 percent. Alternatively, they would concentrate on comparable bonds in other countries. The source-based taxation would therefore change the market conditions in country A if foreign investors who benefit from a special tax treatment played such an important role. Of course, in the aforementioned example it is the combination of specific tax rules in the residence-country together with the source-country taxation which can lead to a distortion. From a theoretical point of view, the question could be raised whether those institutional investors should be treated differently from any other investors in the state of residence. And in fact, a strict limitation to a source-

[55] In my opinion, the investor will not in all cases claim an after-tax risk premium which is a full equivalent of the additional risk. For example, a high-risk junk bond investor considers the possibility that the bond will not be repaid by the company. If the investor has the possibility to deduct the complete loss of the investment and to offset the loss with other positive income in the residence country he will not necessarily require a full risk compensation since the losses will be shared with the residence state. That means the taxes paid on the risk premium which cannot be shifted to the debtor can be considered a kind of loss compensation insurance (paid to the tax authorities of the residence country).

[56] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (317).

[57] See in this respect Hufbauer, assisted by Joanna M. van Rooij, U.S. Taxation of International Income, Blueprint For Reform, Institute For International Economics (1992), pages 65, 66.

based taxation would avoid the aforementioned distortions. There would be no different treatment in the state of residence. However, as long as the residence state of the investor follows a residence-based taxation with exceptions for certain institutional investors, an increase in the income taxation in the source country would have an impact on the investment decision of those investors. Similar aspects apply to the situation where a tax loss carry forward is available to a substantial number of investors. As long as positive foreign income can be offset against this tax loss carry forward, the decision where to invest is influenced by the tax rate in the foreign country. Again, an approach which strictly focuses on a source-based taxation would lead to a different outcome.

What is outlined above with respect to the portfolio investment in bonds is in general also true for portfolio investments in share capital. If the portfolio investment in share capital becomes less attractive, the raising of share capital as well as the debt financing will be influenced negatively. That means, companies operating in the foreign market will not only have to pay a higher interest rate for loan amounts but will also receive less amounts of capital for the issuing of new shares.

Therefore, the residence-based taxation and the source-based taxation can both influence the market conditions in the country where the debtor carries out his activities. However, given the fact that creditor states are often high tax states, the distortions caused by the residence-based taxation will most certainly be greater than those caused by the source-based taxation. From a competitiveness point of view the changing of market conditions in the debtors' country caused by the distortions outlined above will most certainly have a different impact on equity investments compared to financing activities and the investment in bonds. The overall impact on competitiveness will also depend upon whether the company is part of an international group located outside of the respective market and the dependence on external financing compared to internal financing. It can therefore be concluded that a residence-based taxation of portfolio investments has a negative impact on competitiveness and that a source-based taxation is in general to be preferred.

2.4.3. Investments in Tangible and Intangible Property

The consideration paid for the use of tangible and intangible property (and therefore the income derived from the exploitation of the tangible and intangible property) has to be subdivided since it contains elements which have to be treated differently. It is therefore convincing to separate leasing and royalty payments for the use of tangible and intangible property into four different parts: a compensation for write-offs of the property concerned, a compensation for maintaining the property, a compensation for bearing the risks, and an interest component.[58] The whole transaction could be compared with a purchase of tangible or intangible property which is financed by loan amounts. In such a case the source of the income earned by the seller is in the country where the economic activity is carried out by the seller (and producer).[59] The purchaser, on the other hand, has to bear the consideration for the maintenance and the risk related to the property which also encompasses the decrease in value over

[58] Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 82. See also Vogel who subdivides the payments into three parts since he considers the compensation for maintaining the property and for bearing the risk to be one single part (see Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (318).
[59] In case the seller and the producer are different companies (and countries) it would have to be split up.

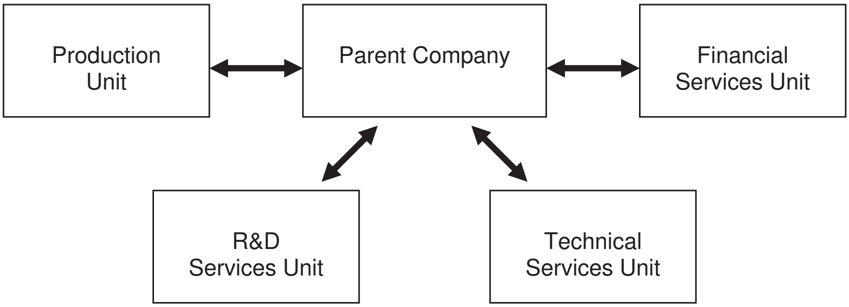
the economic lifetime of the property. Clearly, the source of the latter components would be the place where the purchaser exercises his activities. In contrast, if the property is leased out, the maintenance risk and the risk related to the property - together with the economic depreciation of the property - will have to be borne by the lessor. Therefore, the income has to be split up and the aforementioned components are allocable to the place of the economic activity of the lessor. For the interest component, however, the same principles apply which were already outlined above with respect to portfolio investments, i.e. the interest payment should be taxed in the source country, which is the country where the lessee carries out his income-producing activities.

2.4.4. Hybrid Investments

With the ongoing globalisation and the disappearance of cross-border restrictions it becomes much easier for companies to invest abroad. One of the best examples is certainly the development within the European Union and the abolition of all obstacles to the free movement of goods, persons, services and capital. The unrestricted access to other markets and the possibility of an unhindered establishment of companies in other Member States will increase the number of cross-border activities. Even medium-sized companies are able - and perhaps even forced - to invest in other countries. The typical multinational company of the past - most often huge international groups and conglomerates - will be accompanied by medium-sized companies with activities throughout the European Union and other parts of the world. However, it is not only the typical direct investment which is described above, i.e. a foreign investment in order to expand the existing activities to a new market, but also the relocation of existing activities and the separation of business activities. It is much easier for companies to allocate business functions to other countries in order to achieve the most favourable result. Again, the decision for any relocation will be made by considering all factors relevant to business - most often cost factors. For example, the decision to establish a group service centre in another country will certainly be influenced by several aspects. Labour costs can play a role as well as legal aspects, office rents and other related expenses, and perhaps also language skills of the respective employees. Due to the difference in tax rates and tax systems, the total tax burden can be of importance for such a decision, too.[60] The typical structure in which a parent company provides headquarter-functions to subsidiary companies will certainly be replaced more and more by service and production centres outside of the headquarter country.

[60] However, see - for example - The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Report and Analysis, National Foreign Trade Council, Washington (December 15, 2001), page 7: *"(...) the basic suggestion that tax motives are what drive U.S.-based companies into the international marketplace is seriously antiquated in the context of the global economy."*

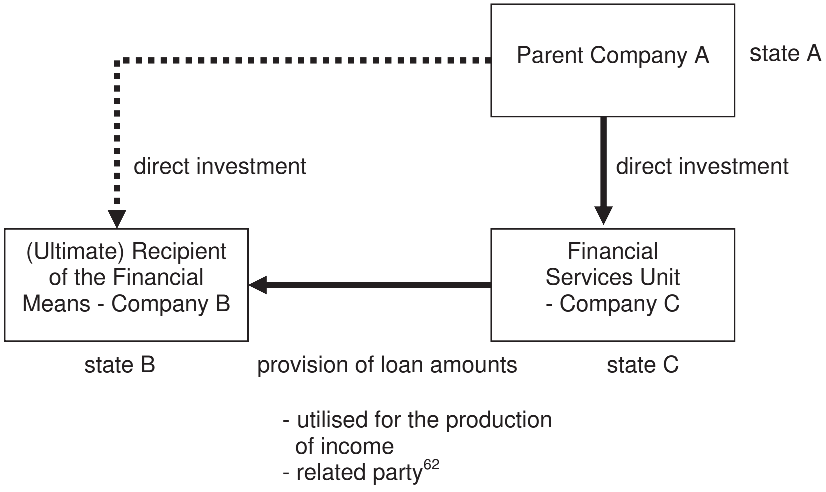
Figure 1:



However, the situation here is a bit more complex than the situation described earlier with respect to direct investments. It is not only the direct competition of one service centre with another service centre but it is the competition of functions and therefore cost factors. Whereas in the simple example of a direct investment in a foreign market the requirement to provide for equal conditions is fulfilled by exempting the foreign income from domestic taxation (or to allow the deferral of income of a foreign subsidiary), the scope now has to be widened and is not limited to a certain market. It is more or less the competition between multinational companies as a whole. For example, if a parent company in country A with subsidiaries in countries B, C and D establishes a group service centre in country E (which provides services to the group companies A, B, C and D), it is, of course, relevant from a competitiveness point of view whether the profit of the foreign service centre is currently taxed in country A or not - compared to a parent company in country F with subsidiaries in countries B, C and D and a comparable group service centre in country E which is not currently taxed. In this example, the multinational company in country A would not be able to benefit in the same way from relocation or centralisation of functions as the multinational company in country F. The question arises whether there is an economic "justification" for a different treatment compared to the direct investment outlined above. One reason could be that the argument of competitiveness does not play an equally important role. I do not think that this is the case. The existing possibilities to transfer functions to group companies in other countries definitely lead to a competition of cost factors. The immediate taxation by the residence country of profits derived by the business units abroad would increase the costs related to these functions and therefore make the group as such less competitive. Similar to what was said with respect to the direct investment, it is important to provide for equal conditions instead of artificially distorting the activities. Of course, the service centre in the example often does not provide services to customers in the market where the company is established. But this is rather typical when functions are allocated to a place where it is most advantageous from a group perspective and several other international group companies take advantage of the services. There is no convincing argument to allow the distortion of competitiveness just because of the fact that a group of companies structures its activities by "international function allocation," with the consequence that the service provider and the recipient of the services are typically related parties. It is therefore important to recognise that a company must be able to freely decide - without any restrictions - to transfer functions or to create new functions outside of the national territory.[61] Each function transferred or created has to be measured and the profit attributable to the respective function is to be taxed in the country where the function is exercised, i.e. normally where the subsidiary or permanent establishment is located. This is of utmost importance from a competitiveness point of view. If one agrees that direct investments should be taxed where the business is carried on, the same must be true for business activities which are split up over different countries. The different functions added together are to be seen as the complete business activity of the group.

In addition to all the business functions and risks there is, in my opinion, one feature which has to be considered and should not be overlooked: the interest component of capital. The aforementioned intra-group separation of functions and risks may result in the establishing of services which are mainly based on the provision of capital, such as financing services, leasing services, and licensing services. As a consequence thereof, inter-company income streams are created which include a separable interest component related to the capital provided and this interest component is one of the most important components of the overall compensation. For this reason, I consider the creation of capital-intensive inter-company services by allocating those functions and risks to separate legal entities to be a "hybrid investment." It is called hybrid investment because it combines the elements of a *direct investment* - by incorporating a subsidiary (service) company in another state - and the elements of an *indirect investment (portfolio investment)* - by focusing on the provision of capital in return for (indirect) interest payments. Of course, a direct foreign investment remains a direct foreign investment, but the intra-group structure - as a whole - contains important portfolio type elements. Such a "mixture" can be considered, in my opinion, a hybrid investment.

<u>Figure 2:</u>



[61] Of course, a transfer of functions can reveal some transfer pricing question, e.g. where a know-how transfer is involved.

[62] Theoretically, the recipient of the loan amount can also be the parent company. It shall be assumed, however, that the financial means are utilised by the recipient for the production of income (in the state of the recipient) and is not just a "circle" transfer of financial means.

Figure 2 shows a direct investment of company A (state A) in state B and state C. However, all or part of the financial means which are invested through capital increase in state C are finally flowing to state B - and are utilised for the production of income in the latter state. Essentially, instead of providing the financial means directly to company B (e.g. by capital increase or loan amount), company C is interposed for the *transformation* of the financial means from equity investment to portfolio investment. Thus, even though the investment is to be seen - from the perspective of state A - as a foreign direct investment, the intra-group structure creates portfolio-type elements - within the group - and can therefore be seen, in total, as a hybrid investment.

In other words, such hybrid investments result in the relocation of functions and risks which are mainly related to capital-intensive services - with a separable interest component - and which are utilised by another (related) party, i.e. the capital is not *directly* employed for an income-producing activity of the subsidiary, but for an income-producing activity of the recipient of the services. The latter can also be the parent company. The subsidiary, of course, realises income from providing capital, but not from the *direct* utilisation of capital in an income-producing process (of the subsidiary). One has to keep in mind that those structures and the newly created services may emerge from an existing headquarter-activity, and that the appearance of the group towards customers might not even be affected, i.e. may be unchanged (before and after the re-structuring). The fact that one of the income elements is a separable interest component may be of particular importance in the context of this study. The reason is that it might be justifiable, or even required, to treat (all or part of) the interest component differently from any other income components which are related to the carrying out of the functions and the taking over of risks by the service provider. This will be clarified in the following. First, however, it seems to be necessary to have a closer look at the interest component itself.

2.4.5. The Basic Interest Component

I fully agree with the position that capital cannot by itself create income. It does not matter in which form an investment is made, by granting a loan to a company or by participating in a company through an equity investment, it is always necessary for someone to be “active” in order to produce “new” income. In case of a loan agreement it is the debtor who adds value to the invested money and part of the added value is passed on to the creditor.[63] And even though the capital factor is an inevitable prerequisite for the production of interest this does not mean that interest is produced by capital.[64] However, capital can exist in different forms, and the most fungible form of capital is money. If one has capital available in the form of money, or changes another form of capital into money, it offers the possibility - without much effort - to invest this money and to receive a certain return. For example, an investor could simply lend the money to the United States Federal Government by purchasing Treasury Bills, Treasury Notes or Treasury Bonds. The investment would produce income in the form of interest on a yearly basis until maturity. This would require a one-time effort of the investor which is relatively small. The interest income received would contain different components:[65]

[63] Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 432.
[64] Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 433.
[65] See, for example, Ruby, The Risk and Term Structure of Interest Rates, which can be found in the internet under http://www.digitaleconomist.com/int_4020.html.

- *The real interest rate*: it is to be considered the compensation, over and above inflation, that the investor wants to achieve for lending the money (the desired rate of return). Since capital is a resource which can be borrowed, the borrower pays the lender for the use of the capital. When money is loaned the lender defers consumption or use of the money for a specific period of time.[66]

- *The inflation premium*: a part of the interest rate is the compensation for the inflation the investor expects and the risk that the expectation could be wrong. The latter is especially relevant in case of long term investments.

- *The liquidity premium*: the liquidity premium represents the amount of compensation required by a lender for a long term investment. Bounding capital for a longer period of time is typically accompanied by a higher degree of uncertainty compared to a short term investment. Apart from the risk of inflation which is already included above in the inflation premium, there are, *inter alia*, political and economic uncertainties which typically have to be compensated.[67]

- *The risk premium*: the risk premium reflects the credit risk involved in a particular investment and is related to the borrower and his activities. Depending on the borrower, there is a different degree of probability that the borrower is able to regularly make the interest payments and to repay the principal amount of debt in whole or in part. It is generally said that the United States Federal Government debts outlined above do not contain such a credit risk. The borrower will be able to properly service the debt and repay the principal at all times, because the United States Federal Government can always borrow new funds at whatever rate of interest necessary to pay existing interest obligations or to repay any existing debt. Moreover, the United States Federal Government has the sources of tax revenue and the power to establish or perhaps create the currency necessary to meet its existing obligations. However, even though - in my opinion - there can be a theoretical risk involved in long term bonds which is not covered by the liquidity premium, it can certainly be said that the credit risk connected with the United States Federal Government Treasury Bills, Treasury Notes or Treasury Bonds is close to zero or even zero (in case of a short-term investment).[68]

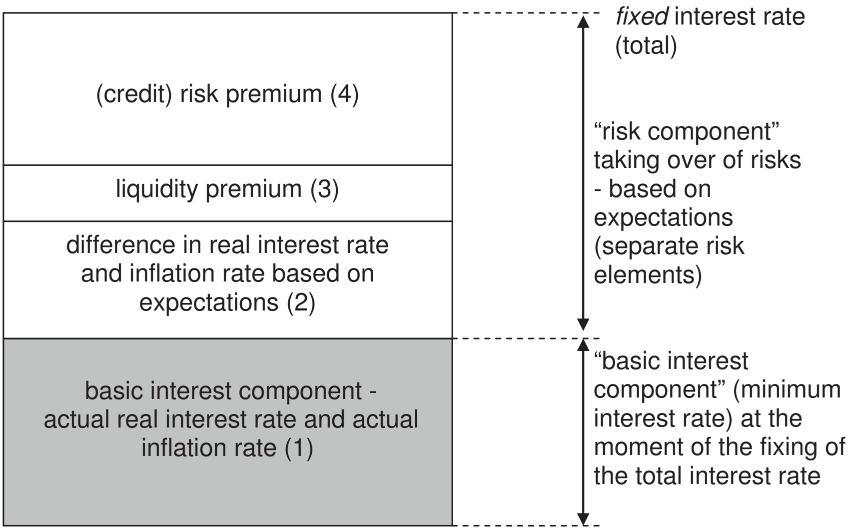
The interest income which can be derived from the provision of capital encompasses the aforementioned elements. It is clear, however, that the interest rate is strongly dependent on the investment decision. If the investor decides to invest the amount of

[66] See to the concept of interest - in general - Fisher, The Purchasing Power of Money: Its Determination and Relation to Credit, Interest, and Crises (1922) and Fisher, The Theory of Interest: As Determined by Impatience to Spend Income and Opportunity to Invest It (1930).
[67] See with respect to liquidity risk (and liquidity premium) van Deventer / Imai / Mesler, Advanced Financial Risk Management: Tools and Techniques for Integrated Credit Risk and Interest Rate Risk Management (2005) and Crockford, An Introduction to Risk Management (1986).
[68] This, however, is not true for a great number of other governments. With respect to developments on a larger scale and the remaining risks involved see William J. Bernstein, The Societal Risk Premium, which can be found in the internet under http://www.efficientfrontier.com/ef/901/society.htm. See with respect to credit risk also Bluhm / Overbeck / Wagner, An Introduction to Credit Risk Modeling (2002); Duffie / Singleton, Credit Risk: Pricing, Measurement, and Management (2003); de Servigny / Renault, The Standard & Poor's Guide to Measuring and Managing Credit Risk (2004); Lando, Credit Risk Modeling: Theory and Applications (2004).

capital in a currency with a relatively high inflation rate, the inflation premium will be higher than in case of an investment in a currency with a relatively low inflation rate. If the investor decides to invest in a long-term high-risk corporate bond, this will not only affect the inflation premium (because of the expected inflation for the period of investment), but also the liquidity premium and, of course, the risk premium related to the debtor. In my opinion, it makes some sense, in the context of this study and in the light of the hybrid investments which were outlined above, to make a further (general) categorisation of the interest elements. It is absolutely clear that any investment decision which is based on *expectations* contains elements of risk. If a decision has to be made in advance for a certain period of time, e.g. the stipulation of an interest rate for one month, there is the risk that the expectation at the moment when the decision was made does not match with the actual rates determined afterwards (retrospectively). The risk can be limited, however, by reducing the period for which the evaluation has to be made, i.e. the shorter the period of time, the higher the likelihood that the expectation matches with the actual rates. This is foremost due to the fact that the number of events which may finally result in a deviation (in comparison to the expectation) are theoretically limited because of the shorter period of time. The basis for making an estimation is therefore in the latter situation more reliable than in case of a longer period of time. But even the limitation to a very short period of time does not completely eliminate the risks. The only possibility to eliminate the risks for the investor (and therefore logically also the chances of an investment) is a completely flexible investment - without credit risks - which permanently adjusts the real interest rate and the inflation premium on an actual basis and not based on expectations, i.e. a variable interest rate which is linked to the changes in the inflation rate (a “rolling” interest rate). If this is the case, the investor receives a real interest rate which permanently reflects the market conditions and an inflation premium which covers the actual inflation rate. Essentially, the wealth of the investor who provides the capital will be increased by the permanently adjusted real interest rate of a variable investment, because the inflation premium which is included in the basic interest component covers, in this situation, exactly the actual devaluation of money.[69] In my opinion, the “rolling” real interest rate and the “rolling” inflation premium can be seen, in combination, as the “basic interest component” (it can also be called the “basic interest rate” or the “basic interest income”). In other words, the basic interest component reflects the result of the actual real interest rate and the actual inflation premium, but without encompassing any additional elements which are based on expectations, such as the differences in rates for an investment which is not a completely flexible investment, the liquidity premium, and the (credit) risk premium. The latter risk elements can be seen as the “risk component” of the (total) interest income. The combination of the basic interest component and the risk component within a *fixed* interest rate can be illustrated as follows:

[69] The increase in wealth (of the creditor) is caused by the debtor, because the latter produces the income.

Figure 3:



Explanations:

(1) The basic interest component reflects the actual real interest rate and the actual inflation rate at the moment of the fixing of the total interest rate.
(2) The expected development of the basic interest component is covered by a premium on the actual basic interest component (in case of an expected increase) or a reduction from the actual basic interest component (in case of an expected decrease). The figure shows an expected increase over the period of investment.
(3) The liquidity premium is a risk element which is related to the period of investment.
(4) The (credit) risk premium is related to the risk of the debtor and his activities.

In my opinion, it is quite important to understand the differences between the basic interest income, as a separate component, and the interest income which contains both components, i.e. including the risk component and the basic interest component. Theoretically, the decision for deriving *only* the basic interest income is a decision which eliminates the investment risks in favour of deriving a minimum income. It is absolutely clear that such a decision does not exclude the uncertainty about the question how the interest rates will develop and whether the inflation rate will increase or decrease in the future. But *uncertainty* is not necessarily the same as *risk* (in this context). In this respect, the basic interest component can be seen as "the status quo on a rolling basis", i.e. it will always reflect the existing situation. If the inflation rate increases, the basic interest component increases. If the inflation rate decreases, the basic interest component decreases. The same is true for the real interest rate: if the real interest rate increases, the basic interest component increases, et cetera. The mechanism is quite simple and not very spectacular.[70] The decision for deriving interest income which does only reflect the basic interest income is therefore a decision with very limited consequences. The "forgiving of opportunities

[70] This can easily be achieved by variable (or floating) rates and bonds which are, for example, inflation linked ("inflation indexed").

by not taking risks" is, of course, a consequence of such a decision. However, what is necessarily required for deriving the basic interest component is capital. Without the provision of capital for an income-producing activity there is no possibility whatsoever for deriving the basic interest income. For this reason, the basic interest component is a component which is, in my opinion, strongly connected to the capital itself, even though it must be produced - in the same way as any other element included in the interest income - by the debtor.

In principle, the basic interest component can be seen isolated as a component to derive a minimum rate of return *and* as a necessary element embedded in the total amount of interest income. Here, the differentiation becomes important. For example, if an investor decides to invest in a long-term corporate bond with a fixed interest rate, he takes over all of the risks which were outlined above and which have to be covered by the amount of interest income. What is decisive, however, is the fact that those risks have to be covered by all of the elements "beyond" the basic interest component, i.e. by the difference between the total amount of interest and the basic interest component at the moment when the decision is made. In other words, all of the *expectations* of the investor - and therefore the uncertainties which have to be seen, in this case, as potential risks - have to be implemented in the risk elements. Those risks are caused by the fact that the investor has to decide in advance on the acceptability of an interest rate stipulated for a certain period of time. The risk elements have to cover, *inter alia*, the expected change of inflation and the real interest rate during that period, the possible non-disposability of the investment during that period, and, of course, the credit risk of the debtor. A very good example which supports the approach of a (theoretical) separation between the basic interest component and additional risk elements in the total amount of interest income is the provision of a guarantee. Even though the guarantee does not necessarily cover all of the risks involved - and therefore the complete risk component - it may cover substantial risks, especially those related to the debtor. The guarantor does not provide the capital which is the basis for deriving the interest income, but only provides the guarantee which influences the interest rate (if the guarantee is provided to the debtor in favour of the creditor).[71] I will come back to that aspect later on. What is of importance here, however, is the fact that the decision for taking additional risks in order to derive a higher income can have serious consequences for the investor. In theory, there should be an acceptable balance between the (potential) amount of income and the risks taken for deriving this income. Again, it must be clear that the basic interest income is not part of this "risk balance" but a separate component. Of course, this does not mean that the investing of capital and the taking over of substantial risks does not affect the basic interest component. If, in the example above, the corporation is not in a position to pay the yearly interest, the investor will neither derive the income which is related to the risk elements nor the basic interest

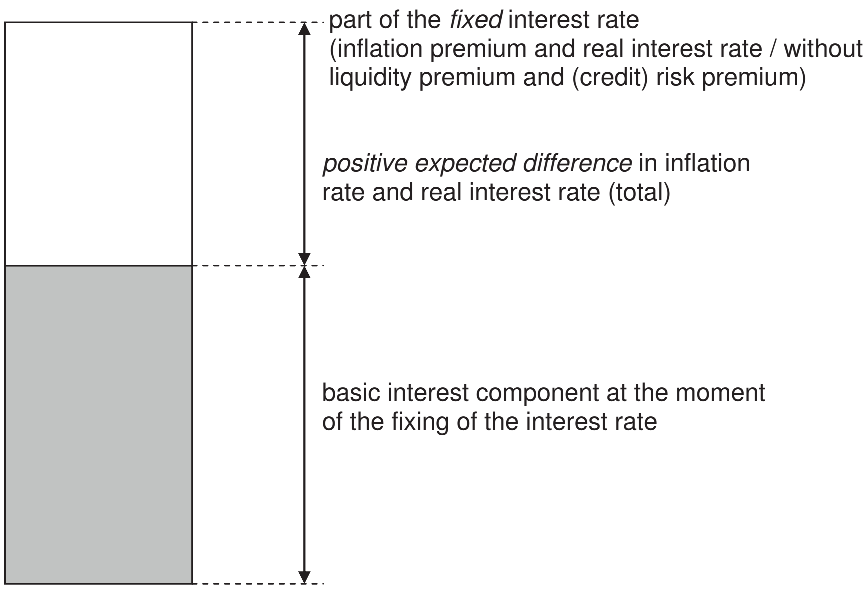
[71] Credit default swaps (CDS) are derivatives which are designed to transfer the credit exposure of fixed income products between parties. CDS can be used to hedge an investment position for a certain period of time and, therefore, to transfer the default risk to another party (or parties) for a certain fee. One of the models to determine the price of a CDS is the so-called 'no-arbitrage' model. Without going into detail of the pricing itself, it is important to note that a certain risk-free rate is taken into account as an important element. For Hull and White the US Treasuries are reflecting the risk free element (Hull / White, Valuing Credit Default Swaps I: No Counterparty Default Risk, which can be found in the internet under http://www.rotman.utoronto.ca/-hull/DownloadablePublications/CredDefSw1.pdf; Hull / White, Valuing Credit Default Swaps II: Modeling Default Correlations, http://www.smartquant.com/references/SWAP/swap2.pdf). For Duffie it is the LIBOR which - in the model - is considered the risk free rate (Duffie / Singleton, Credit Risk: Pricing, Measurement, and Management (2003)).

income. In a worst case scenario he will even lose the principal amount of investment which was provided to the debtor. In a typical case the risk component in the interest income should be sufficient to cover the risks and should result in an appropriate return on investment - otherwise the investor would not be willing to take over the risks. But this is a different question: the fact that the taking over of risks may also affect other elements, apart from the risk elements, and even the property which is the basis for deriving interest income, does not influence the aforementioned classification.

On the other hand, the debtor will usually accept, in principle, the existence of the elements described above and will accept the necessity of compensating these elements. This, at least, is true in a market without significant distortions in favour of one of the two parties. Theoretically, the basic interest component, i.e. the compensation of the actual real interest rate and actual inflation rate, can be seen as the most objective component. The reason is that these elements can be measured in time (on an "actual" basis). The risk component is based on expectations and is therefore more difficult to determine. The development of - for example - the real interest rate, the inflation rate or the risk related to the debtor might be estimated differently by the creditor and the debtor. Hence, depending on the situation (e.g. whether a rating of the debtor exists or not), the determination of the appropriate risk component can be extremely difficult. In other words, the fact that the elements, in principle, must be compensated should be obvious for the creditor and the debtor, but this does not solve the (practical) problem of finding an appropriate interest rate.

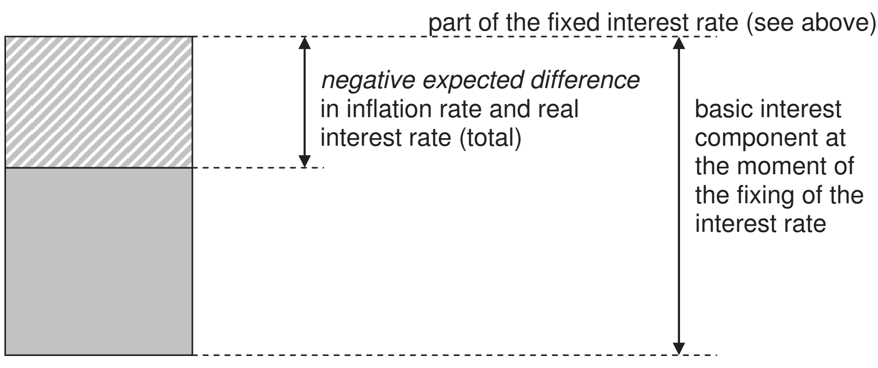
As already mentioned above, it is likely that a difference exists between the (actual) basic interest component - at the time of stipulating the fixed interest rate - and the *expected* average basic interest component over the period of investment. The expectation may result in a positive or negative deviation from the (actual) basic interest component. The deviation is positive, i.e. should lead to a premium within the fixed interest rate, if an increase in the basic interest component is expected.

Figure 4:



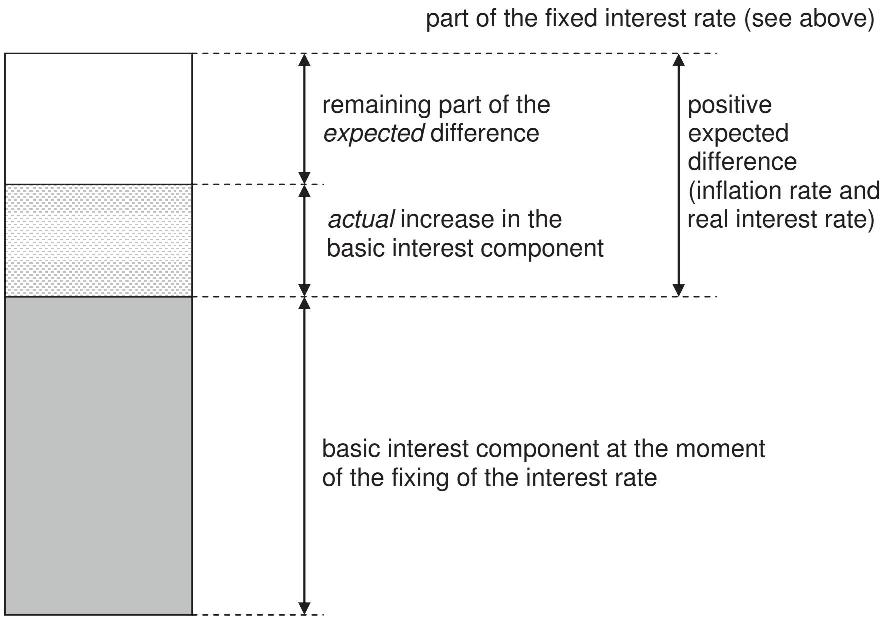
However, it is also possible that a percentage of real interest rate and inflation premium is stipulated within the fixed interest rate which is below the (actual) basic interest component. Such a negative difference may exist if a decrease in the average basic interest component is expected over the period of investment.

Figure 5:



Supposing the fixed interest rate contains a positive difference between the (actual) basic interest component - at the time of stipulating the fixed interest rate - and the expected average basic interest component over the period of investment. At first glance, it seems that a strict differentiation between the risk component and the basic interest component, without any overlapping over the period of investment, can only be guaranteed if the latter component is static - and not determined on a rolling basis. However, it has to be noted in this respect that the premium (and the taxation of the premium) and the actual development of the risks (and the treatment of such risks for tax purposes) are two different subjects. I will come to that aspect later on in more detail. The actual basic interest component over the period of investment may - in an extreme case - go up to an amount which might even exceed the total amount of fixed interest (not only the expected premium).[72] In turn, it is also possible that the actual basic interest component stays below the original level.[73] Both scenarios show that the actual development is obviously different from the expectations which found expression in the fixed interest rate.[74]

Figure 6:



It is very important, however, to recognise that it is the additional risk premium related to the differences in real interest rate and inflation rate which covers exactly the risk that the (actual) basic interest component might increase over the period of investment - and might even exceed the expectations. The other risk elements have

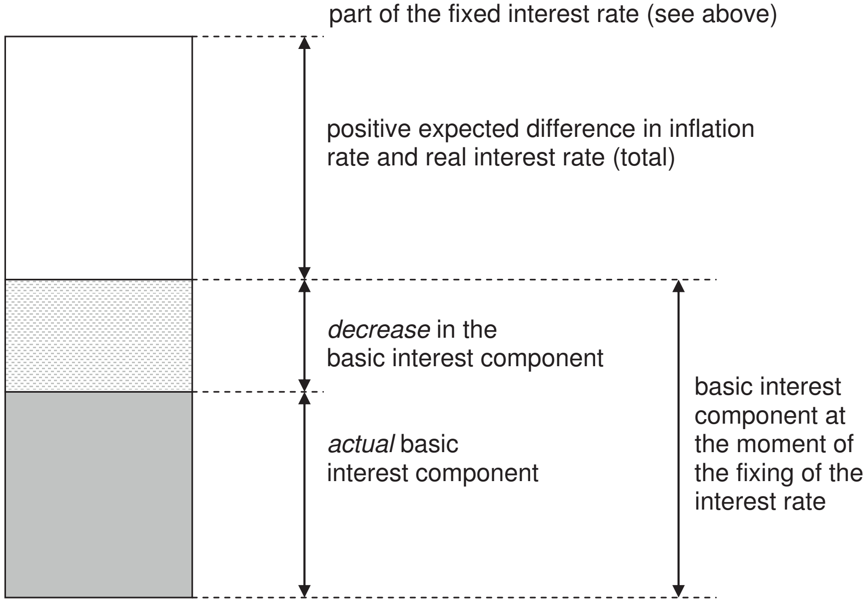
[72] For example, the basic interest component is determined with 2 percent, the risk component with 3 percent, i.e. the total amount of fixed interest is 5 percent. Theoretically, the actual ("rolling") basic interest component - over a certain period of time - might go up to 6 percent and is higher than the total amount of fixed interest (which, in this example, is 5 percent).

[73] For example, the basic interest component is determined with 2 percent, but the actual ("rolling") basic interest component is - in average over the period of investment - only 1 percent.

[74] In general, what is true for a positive difference is also true for a negative difference. Here, there is the potential risk that the basic interest component increases (and not decreases) during the period of investment.

the purpose of covering additional (separate) risks (e.g. the risks related to the debtor, the non-disposability of the investment). Of course, the taking over of risks provides - at the same time - additional chances. In the best case, a positive premium is stipulated within the fixed interest rate, but the actual basic interest component over the period of investment decreases.

Figure 7:



The aforementioned issue does not exist if the investment is completely flexible, e.g. if the investment is repayable at any time and the interest rate is variable instead of fixed. Of course, the investment would still require a risk premium in order to cover the risks related to the debtor and the possibility that the debtor will be unable to repay all or part of the investment (and the interest). But it is not required to provide for a premium which covers the risk related to the future development of the real interest rate and the inflation rate if the increase (or decrease) of the rates finds expression in a permanently adjusted interest rate, i.e. if these risks (and the chances involved) are shifted to the debtor.

Overall, it can be concluded that the interest income encompasses two very different types of components: the basic interest component, which can only be derived because of the provision of capital - and which is therefore strongly connected to the capital itself - and the risk component, which has to cover all of the potential risks which are caused by the debtor and the period of investment. The risk component, however, may theoretically be “stripped,” at least partly, from the provision of capital, e.g. through a guarantee which covers the debtor’s risks. The question arises whether these conclusions are of any relevance from an economic perspective. Here, it seems to be important to make a differentiation between a source-based taxation of interest income and a residence-based taxation of interest income.

a.) The source-based taxation of interest income (“optimal scenario”)

The previous examinations show that the source-based taxation of interest income is, from an economic perspective, the preferred solution. It can therefore be considered the optimal scenario. If the respective tax system provides for such a source-based taxation of the total amount of interest income, there is no reason for any separation of the aforementioned components.

b.) The residence-based taxation of interest income (“non-optimal scenario”)

The situation is different if the interest income is subject to a residence-based taxation instead of a source-based taxation. It is more than questionable whether such a non-optimal scenario must necessarily be accepted by all of the states which are somehow involved in the investment activities. For example, in those cases where interest streams are created on an intermediate level, like in case of the hybrid investments outlined above, the question arises whether the result of a residence-based taxation of the interest income (on the intermediate level) should be accepted by the state of the parent company. Such a structure - in combination with a residence-based taxation - does not lead to an optimal economic result. In this respect, it seems to be necessary to provide for a differentiation which is based on the basic interest component and the risk component. I will go into detail of this aspect in the following.

2.5. Application of the Principles to Hybrid Investments and other Intra-Group Activities

2.5.1. Production Activities

The relocation of production activities to countries with lower production costs is very often connected with an extensive capital transfer to the other country. In many cases the production activities are restricted to intra-group transfers, i.e. the foreign subsidiary produces parts only for the supply of the parent company or other group companies without any sales activities towards third parties. Everything that was outlined above with respect to direct investments is equally relevant in this situation. The income produced by the foreign subsidiary with regard to the production activities is allocable to the respective country. Of course, in practice problems with respect to transfer pricing will come up but this has nothing to do with the general economic conclusion. Even in the context of controlled foreign company legislation the production activities are most often not targeted, with the effect that the proposed economic conclusion is generally in line with international tax practice.

2.5.2. Service Activities

In contrast to the relocation of production activities, the relocation of service activities is not always accompanied by extensive capital transfers and investments in the foreign country. The relocation of functions to other countries is, in my opinion and as already described above, to be treated in exactly the same manner as the relocation of production activities. This is, first of all, required from a competitiveness point of view which is equally relevant for intra-group production activities and intra-group service activities. The intra-group functions allocated to foreign subsidiaries should - from an economic standpoint - be taxed in the country where the functions are exercised. As already outlined earlier, any restriction of foreign investment caused by a residence-based taxation would not lead to an efficient allocation of capital but to a distortion of competitiveness. This is especially true when the residence-based taxation is applied to investments where the difference in tax rates between the residence country and the source country is relatively high. In such a case it is rather likely that other investors will step-in and create the functions in the respective foreign country. If the company refrains from investing directly in the lower-tax country because of the residence-based taxation but instead uses the services of third party suppliers, no efficient allocation of capital takes place. Instead, the company has a real disadvantage in comparison to companies which can directly take advantage of the lower tax rate in the foreign country.

For example, a parent company established in country A provides certain headquarter services to the subsidiary company B. The tax rates in country A and country B are both 35 percent of the taxable income. The consideration for the services provided by parent company A amounts to 105 Euro. The personnel and other expenses related to those services are 100 Euro, i.e. the profit realised in country A is 5 Euro. Suppose the after-tax result of 3.25 Euro is exactly the amount which covers the function and the risks related to those services. The overall after-tax result on a group level related to the services is -65 Euro (or a tax reduction of 35 Euro).[75] Assuming that there is a possibility to relocate the services to country C without any relevant disadvantages and the tax rate in country C is only 10 percent, the overall tax burden could be reduced by 1.25 Euro.[76] From a competitiveness point of view it would make sense to transfer the functions in question to country C. However, this is not true if the taxable result in country C is currently taxed in country A. The result would be the same and therefore the parent company would not be willing to take over the burden connected with the incorporation of a new subsidiary (or permanent establishment) in a foreign country. In case the services can be rendered by companies outside of the group it is likely that local companies in country C or subsidiaries of multinational companies which are not taxed on a current basis take over those functions. Because of the fact that the functions and risks are covered with an after-tax result of 3.25 Euro the local companies are able to offer the services at a price of 3.61 Euro (or a bit higher).[77] Depending on the function itself and the importance within the group it could make sense to outsource the function to a company in country C. The business expenses of the subsidiary company B will be

[75] The business expenses of 105 Euro in country B lead to a tax reduction of 36.75 Euro and therefore to after-tax expenses of 68.25 Euro. The taxable profit in country A amounts to 5 Euro (105 minus 100) and consequently to an after-tax profit of 3.25 Euro. The overall after-tax result is therefore -65 Euro (-68.25 Euro + 3.25 Euro).

[76] Under the assumption that the services are still charged with 105 Euro and the expenses related to those services are still 100 Euro, i.e. the taxable profit derived in country C is 5 Euro. An effective tax rate of 10 percent improves the after-tax result from 3.25 Euro (in country A) to 4.5 Euro (in country C).

[77] The exact amount depends on the treatment at the time when the deferred income is distributed - for example - to a parent company in country D. If the distribution is tax exempt, the price of 3.61 Euro is realistic In the example it is assumed that the functions and risks are covered with an after tax result of 3.25 Euro (taking into account a tax rate of 35 percent). The reduction of the tax rate from 35 percent to 10 percent makes it possible to reduce the price for the services from 105 Euro to approximately 103.61 Euro. The net income before tax of 3.61 Euro will lead to an after-tax result of 3.25 Euro (3.61 Euro minus 0.36 Euro (10 percent) income tax). If the distribution is taxed in country D with a rate of 35 percent (combined with a foreign tax credit of 10 percent), the price will be higher than 3.61 Euro but below 5 Euro - depending on the planned deferral of income in country C.

reduced from 105 Euro to 103.61 Euro. Even though the parent company A will not receive the positive income connected to the rendering of the services the after-tax expenses will only increase from -65 Euro to -67.35 Euro.[78] In other words, the outsourcing of the services does not result in an after-tax reduction of income of 3.25 Euro (which would be equal to the functions and risks) but only to a reduction of 2.35 Euro. From an economic point of view the outsourcing could make sense, especially if it is related to auxiliary functions. However, if the capital allocation was not efficient in case of the planned direct investment, it will not be efficient in case of the outsourcing. Therefore, it would be better from a competitiveness point of view to not restrict the investment of the parent company A in country C by a residence-based taxation but instead to allow the deferral of income (in case of a subsidiary). This is not only true for the allocation of key functions but in the same way for less substantial functions. Outsourcing should not be more attractive compared to a direct investment just because of the application of a residence-based taxation. The outcome of the example would even be the same when both - company A and the third party service provider - were able to reduce the costs connected with those services from 100 to 95 Euro in case of a relocation to country C.[79] Therefore, the difference in tax rates combined with the application of a residence-based taxation will not lead to an efficient allocation of capital but rather to a distortion of competitiveness.

2.5.3. Intra-Group Transfer and Use of Tangible and Intangible Property

The intra-group transfer of tangible and intangible goods from a group company (e.g. parent company) to another group company (e.g. subsidiary) should be treated in the same way as the sale of property to an unrelated party. The gain realised is therefore attributable and taxable in the country of the seller. The subsequent income received by the purchaser from the making available of the property to other group companies is treated in the same way as outlined above with respect to the first three components, i.e. the compensation for write-offs of the property concerned, a compensation for maintaining the property, and a compensation for bearing the risks. These three components are now attributable to the purchaser. The original connection to the seller (e.g. parent company) does not exist any longer. To a certain extent it can be seen as a mixture of the aforementioned relocation of production activities and service activities. First, the transfer of property is accompanied by a - more or less extensive - capital transfer. Second, the property is made available to group companies by an agreement which encompasses the service functions of the subsidiary. In my opinion, the fact that the property is transferred within a group of companies followed by an intra-group service agreement is not to be treated differently from a third party transaction. The leasing out of tangible property or the exploitation of rights is not necessarily to be made by the group company which originally purchased or produced the property or developed the right. However, this is only true where the voluntary transfer of property is exercised on an arm's length basis. This requires that the estimated earnings of the right are taken into consideration for the determination of the sales price, e.g. by applying the discounted cash flow method. In this case, the seller and the purchaser receive the profit share which reflects the new structure and therefore the new functional allocation within the group of companies.

[78] 103.61 Euro minus 36.26 Euro tax reduction (35 percent).
[79] Under the assumption that the third party reduces the price to a level where the after-tax result in country C is equal to the function and risks connected to those services - which is very likely.

This could be compared to a situation where a parent company has developed an intangible asset and instead of using the asset within the group the parent company decides to sell the intangible asset to an unrelated party. At the same time, a subsidiary company purchases a different intangible asset which is to be used within the group and which shall therefore be made available to other group companies. In this example, the profit realised by the disposal of the asset is completely allocable to the parent company. The acquisition of the new intangible asset (from a third party) is now allocable to the subsidiary company which bears the risks and exercises all the functions which are connected to the intangible asset. It should be clear that the respective components (at least the first three components outlined above) are now connected to the subsidiary and the profit should therefore be attributed to the subsidiary. The fourth component - the interest component - is left open since it will be discussed separately in the following.

2.5.4. The Interest Component of Capital

In all intra-group transactions (and, of course, also in third-party transactions) the interest component plays a more or less important role: The relocation of production activities as well as the relocation of tangible and intangible property is often accompanied by large capital transfers from one country to another country. The same can be true with respect to service agreements where substantial amounts of capital are involved. All of these transactions contain to a certain extent an interest component. The interest component must be seen from the perspective that capital can either be used alternatively or - in case the investment has to be re-financed by a third party (e.g. bank) - cannot be used free of charge, i.e. interest has to be paid. The interest component should find expression in the prices for goods and services. Where a large amount of capital is necessary to produce a certain product or to render a certain service, the interest component should encompass a greater part of the total price for goods and services than in a situation where less capital investments are necessary. Of course, this is not always true since prices are determined by market factors and in some situations not all components calculated in the sales price can be shifted to the purchaser. However, this situation will consequently lead to an insufficient return on investment. Therefore, to be successful in the long run a company must be able to adequately cover all cost and risk factors and therefore also the interest for the capital employed.

In the following, it is important to make an additional differentiation between the general conclusion that the employment of capital has consequently always an interest effect on “the input side” and the fact that the exercising of certain functions contains separable financing elements and therefore an interest component on “the output side.” The separable interest component is particularly relevant in case of all types of financing services and therefore also the hybrid investments which were described earlier.

2.5.4.1. The Interest Component of Capital and Direct Investments

Suppose a holding company established in country A (company A) is the sole shareholder of a subsidiary in country B (company B). The business activity of company A is mainly limited to the holding of shares in the subsidiary company. Company B is engaged in the manufacturing, the marketing and the distribution of goods to customers in country B. The economic activity of company B is carried on in country B only. The shares held in company B and the financial means on the bank account of company A are financed by equity. Company A decides to increase the share capital of company B by 10 million Euro in order to enable company B to purchase a new and highly sophisticated machine to improve the manufacturing process.

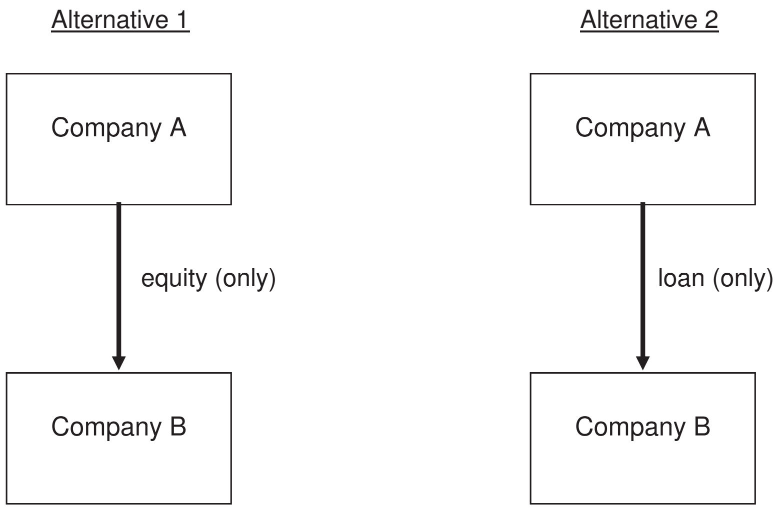
This is a typical situation of direct investment. Based on the principles outlined above the expenses related to the machine (write-off of the machine, maintaining the machine) as well as the savings which can be realised by the new machine will be taxed in country B. From an economic perspective, the amount of capital in the form of financial means will be converted into a tangible asset - and perhaps auxiliary expenses. From a competitiveness point of view there is no other alternative - in my opinion - than to tax the profit realised by this investment in the source country B.

If in an alternative scenario the amount of 10 million Euro is re-financed by a bank loan (i.e. company A pays interest to the bank for the amount of capital increase in company B), the interest expenses are economically connected to the business activities in country B. From an economic standpoint, the expenses should not reduce the taxable result in country A but should be deducted from the income in country B.[80] However, most often this economic requirement is not in line with international tax practice, i.e. the interest expenses incurred in country A (by company A) cannot be deducted from the taxable result in country B (by company B).

Another alternative could be for company A to grant an inter-company loan to company B instead of increasing the share capital. Consequently, a source-based taxation would result in the same overall tax burden as if the amount were transferred by capital increase. This is not true with respect to the taxation of the legal entities involved since the taxable income of company B is reduced by the amount of interest paid and the taxable income of company A (in country B) is increased by the equivalent amount, but this does not matter from an economic point of view. What actually matters here is the fact that the overall tax burden is the same since it is based on the tax rate of country B.

[80] See also Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (320); Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 79.

Figure 8:

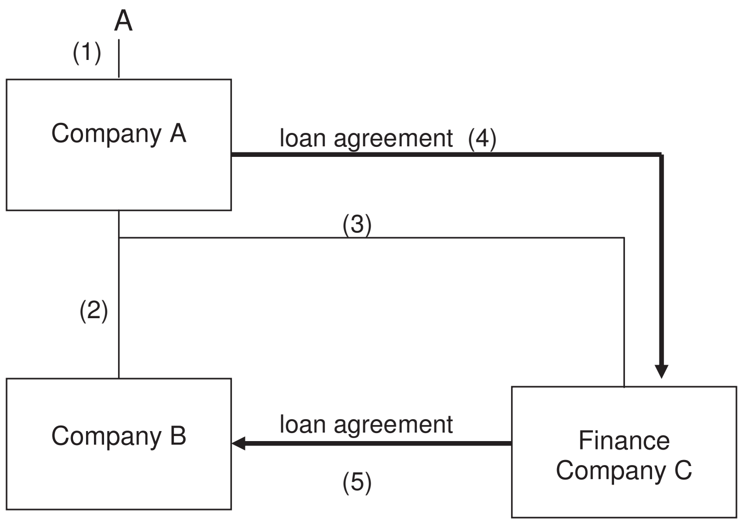


It is quite obvious that the expectations of an equity investor and a loan investor may be different. Suppose company A invests in the equity of company B (alternative 1). The expectations regarding the return on investment in the form of dividend payments or subsequent capital gains on the disposal of shares reflect the risks and therefore the possibilities of the activity of company B itself. It is therefore not only a risk-free rate of return which is expected but an appropriate premium which covers the increased risks inherent in the activity of company B. The mere provision of loan amounts to company B (alternative 2) - in this example without any parallel equity investment of company A in company B - may lead to a different outcome. Similar to the equity investor, company A requires a certain minimum rate of return (risk-free rate of return). In addition thereto, a credit risk premium must be included in the interest payments in order to cover the risks related to the activity of company B. Depending on the circumstances the credit risk premium can be similar to the expectations of an equity investor. This would be the case, for example, where company A is the only creditor of company B, where the amount of equity in company B is relatively low, and where no hidden reserves and goodwill are included in the assets and the business activities of company B. In such a case, the risk position of a creditor becomes comparable to the risk position of a theoretical equity investor, and this would require a comparable expectation regarding the return on investment. However, apart from this rather extreme case, e.g. where company A is not the only investor and company B has sufficient equity, the risk premium included in the interest rate is lower than the expected risk premium of the equity investor. The income which is the basis for subsequent dividend payments (or which will be retained in state B) and the subsequent interest payments is, in both cases, “created” by an economic activity carried on in state B. It is therefore consistent, as already outlined above, to tax this newly created income in state B. Such a strict source-based taxation may be considered an optimal scenario from an economic point of view.

2.5.4.2. The Interest Component of Capital and Intra-Group Finance Activities

In the following alternatives, which are an extension of the basic scenario outlined above, shareholder A - an individual who is resident in country A - holds all of the shares in holding company A which, in turn, is the sole shareholder of two subsidiary companies in countries B and C. The business activity of company A encompasses the holding of shares in the subsidiary companies. Company B is engaged in the manufacturing, the marketing and the distribution of goods to customers in country B whereas company C is responsible for the intra-group financing, which is - for reasons of simplification - in the alternatives mentioned limited to the financing of the activities of company B. The income tax rate in county C is lower than the income tax rates in country A and country B. In the following, different scenarios will be examined.

Figure 9:

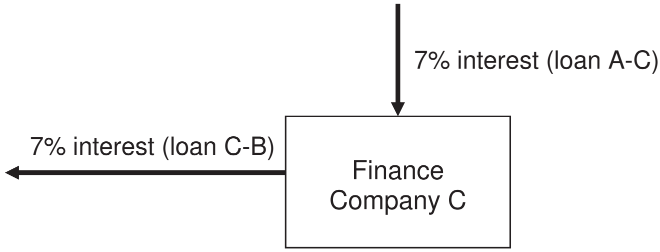


Explanations:

(1) Individual A is the sole shareholder of company A.
(2) Direct investment of company A in country B through a subsidiary company. The business activities of company B encompass the manufacturing, the marketing and the distribution of goods in country B.
(3) Direct investment of company A in country C. The purpose of subsidiary C is limited to intra-group financing activities.
(4) Loan agreement between the companies A and C.
(5) Loan agreement between the companies C and B.

It is assumed in the following that the loan amount granted by company A to company C is exactly as high as the loan amount granted by company C to company B. In general, the principles outlined earlier are equally relevant. However, it might be interesting to have a closer look at some of the possible scenarios. For example, if it is further assumed, for theoretical purposes, that finance company C does not provide any relevant services and the risk related to company C is basically identical to the risk inherent in the loan amount granted to company B (due to the fact that there are no other activities carried out by company C and the loan amount granted to company B is the only substantial asset), the interest payment should be identical or at least nearly identical.[81]

Figure 10:



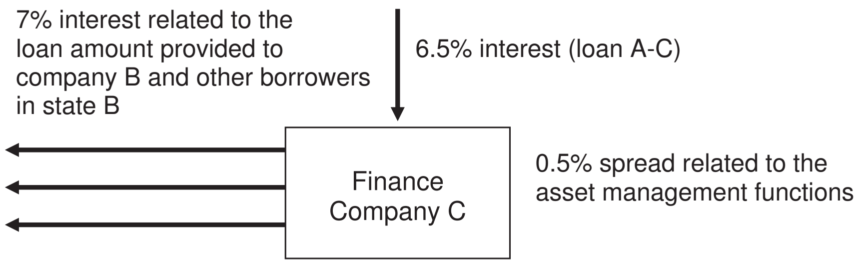
From an economic perspective, the total amount of income related to the interest payment is produced in state B and should therefore be taxed in state B.[82] The interposition of company C does not lead to any other economic conclusion. If the underlying system does not provide for a source-based taxation but a residence-based taxation, the income will be taxed in state A. The reason is that state B, in this situation, normally provides for a deduction of the complete amount of interest expenses for income tax purposes. The same will be true in state C, where the interest paid to state A will be deducted from the interest income derived from state B. Thus, in such a scenario, the complete amount of interest will be taxed in the hands of company A in state A. This is only true to the extent that a possible withholding tax is not taken into account. This would otherwise lead to a limited taxation at source. It must be repeated, however, that the residence-based taxation is not the preferred solution (non-optimal scenario).

The outcome can be different where the finance company C carries out additional functions. If, for example, the finance company C is in a position to split-up the amount and to invest in different loan amounts of borrowers in state B with the effect that the overall risk of investment is reduced, albeit each amount of investment bears a comparable amount of risk, the additional functions of the finance company C have to be taken into account. It should either lead to a reduction of the interest amount payable to company A or to a service fee charged to company A. In any case, finance company C derives income which is allocable to the exercising of asset management functions. The overall risk of the loan investment of company A is reduced in comparison to a direct loan of company A granted to company B (only).

[81] This case would lead to additional tax related questions and may therefore be quite theoretical. However, the alternative is nonetheless useful to clarify the economic aspects.

[82] See in this respect also Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, pages 434, 435.

Figure 11:



In principle, the total amount of interest related to the loan between company C and the borrowers in state B must be created in state B through the economic activity carried on in the latter state. However, it cannot be ignored that the asset management functions of company C lead to additional income which is allocable to state C (if it is assumed that the economic activity is carried on in state C). The "net income" created economically is 6.50 percent in state B and 0.50 percent in state C. A source-based taxation in an optimal economic scenario would therefore require the taxation in those two countries according to the income produced.[83] Again, and in contrast thereto, a residence-based taxation (without considering a possible withholding tax) would lead to a taxation in state C (0.50 percent) and state A (6.50 percent).

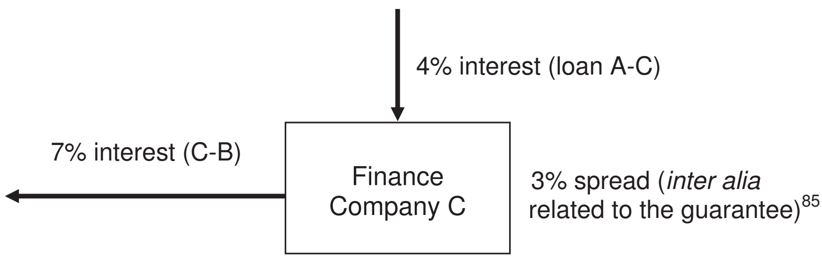
One could even go one step further and assume, just for theoretical purposes, that the loan amount of company A is provided on a variable basis, i.e. the interest rate is subject to permanent adjustments, and can be requested for repayment at any time. It shall further be assumed that finance company C receives a state guarantee in favour of company A for the full repayment of the principal amount of loan including pro rata interest (at any time) and that the credit risk is therefore eliminated. It shall be assumed, in this example, that the state guarantee is provided free of charge, i.e. that the state is supporting the activity. It is clear, of course, that the guarantee which eliminates the credit risk would usually require a compensation. However, the latter aspect does not change the conclusion related to the basic interest component and the conclusion related to the comparison between a loan investment and an equity investment. In my opinion, such an assumption simplifies the comparison and makes the relevant aspects more visible. The variable loan agreement shall reflect, for theoretical purposes, the basic interest component. Finance company C invests the amount provided by company A in a long-term loan granted to company B (only) with a fixed interest rate of 7 percent. In this alternative, the activities of finance company C do not lead to any substantial economic output in state C, i.e. no additional asset management functions are performed in state C. Moreover, it shall be assumed that the very limited functions carried on in state C are compensated separately, e.g. through service fees, and that the structure is not to be considered abusive or leads to any other similar conclusion (because of the fact that there is no substantial activity carried on in state C). Theoretically, under the aforementioned assumptions the compensation for the state guarantee would encompass a substantial part of the

[83] See in this respect also Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 434 et seq.

difference between the interest received from company B and the interest paid to company A.

Again, in an intra-group relationship it is certainly possible to reduce the economic activity of an intermediate finance company to a relatively low level.[84] Nonetheless, it is clear that even minor services (functions) carried out by company C require - from a transfer pricing perspective - an appropriate compensation. These (minor) services may be charged separately, e.g. on the basis of comparable uncontrolled prices or - due to the lack of such information - based on a cost-plus system. Often, the service recipients will be the companies receiving the financial means, but it is also possible that the services are provided towards the parent company. The latter depends on the facts and circumstances.

Figure 12:



In this alternative, a residence-based system (non-optimal scenario) normally results in a taxation of 4 percent interest income in state A. The difference of 3 percent in state C encompasses the risk component which was described earlier and which includes the following elements: the expected *differences* in real interest rate and inflation rate with respect to a long term investment, the liquidity premium and, of course, the credit risk related to company B. It is obvious that those risks may directly affect the tax base of company C: if the development of the real interest rate and the inflation rate was not properly estimated, the variable interest rate of the loan A-C will increase more than expected and will reduce the interest spread (since the 7 percent interest rate of the loan C-B is fixed). In addition, the capital invested in the loan amount C-B cannot be used for any other activities. It may be difficult to transfer the loan receivable to any other party and to request an earlier repayment. This, of course, can also lead to difficulties for finance company C, e.g. in case a more expensive refinancing is required for another (parallel) investment. Furthermore, it is the risk related to the borrower which may have a significant impact on the tax base of company C, especially if company B is unable to repay the principal amount of investment. The latter situation can lead to a significant loss for company C. These risks will not have any direct impact on company A since the real interest rate and the inflation rate will be permanently adjusted. A possible default of company B - and subsequently company C - will not affect, at least not directly, the income of company A, because the loan investment is secured by the guarantee provided in favour of the

[84] The question of “minimum activity” will be discussed later on in more detail.
[85] It is obvious that the spread is - to a substantial part - caused by the state guarantee. The exact percentage depends on the facts and circumstances, e.g. the period of investment and the risk related to the debtor and its activities.

latter company.[86] In the absence of an optimal economic situation - which would require the taxation in state B - the question arises whether, from a merely economic perspective, the aforementioned allocation is an acceptable - but still non-optimal - scenario. In this regard, it is essential to recognise that all of the risk elements which lead to the positive income spread in state C can equally result in negative income in state C. Theoretically, there should be a balance between the compensation for taking the risks, on the one hand, and the likelihood of negative consequences caused by such risks as well as the possible impact of such risks, on the other hand. In other words, the higher the risks, the higher the compensation (and therefore the spread in state C). Based on the previous conclusions, the current taxation of the income spread (the risk spread!) in state A can negatively affect the *competitiveness* of the group. Even though the income is not produced in state C (but in state B) the group structure results in the allocation of (part of) the risks of the activities to state C - through the provision of a loan amount. If this results in the taxation of the *positive* income in state C - due to the double tax convention concluded between state B and state C - it is required that the *negative* income is taken into account in state C, too. The (additional) current taxation of the income spread in state A at a higher rate can take away part of the profits which are required for a (subsequent) loss compensation on a group level. It would have similar effects as the current taxation of income produced in state B. Therefore, if the taxation of the risk elements cannot take place in the state in which the risk elements are produced (state B), the “second best” solution is the taxation in the state to which the elements were shifted according to the existing double tax convention, because the “risks remain risks” - even in case they are partly shifted to another state.

The conclusion is different, though, for the interest income related to the loan amount A-C which shall be equal to the basic interest component. Even though the loan amount was transferred to company B - and is therefore “indirectly involved” in the activities which are subject to an increased risk - it should be recognised that the compensation for the loan amount A-C is not a compensation to cover those increased risks. The interest income includes the compensation for the (actual) real interest rate and the (actual) inflation rate. Such compensation is required for the “lending of money” (real interest rate) and the “maintaining” of the capital (inflation premium). Thus, as long as the capital is “used” by company C - for whatever activity - the latter company has to pay “the lending rate and the maintenance fee” for the provision of capital. The question whether the capital is utilised for a successful or an unsuccessful activity is, at least in this example, not directly relevant for company A. Eventually, the interest income which is paid by company B to company C, and by company C to company A, must be produced in state B. An optimal scenario would therefore require the taxation in state B. However, if the double tax conventions involved are based on the OECD-MTC, the interest income of company A will finally be taxed in state A.[87] Of course, there may be a taxation of the interest in state B and state C, but the taxation is limited.[88]

In my opinion, this is - under the given circumstances of a residence-based taxation - an acceptable outcome. There is no *preference*, in my opinion, for a taxation of the 4 percent interest income in state C instead of state A. The 4 percent interest income is

[86] Leaving aside any consequences in relation to the (parallel) shareholding.
[87] Article 11 (1) of the OECD-MTC.
[88] Article 11 (2) of the OECD-MTC provides for a taxation of the interest which shall not exceed 10 percent of the gross amount of interest.

neither connected to any income-production in state C nor does it reflect any risk compensation element in the relationship C-B. In fact, I do not see any (other) economic reason - in such a situation - for a preferred taxation of the basic interest income in state C. The income which is related to the basic interest component should therefore be taxed - in the absence of an optimal scenario - in the residence state of the company which provides the capital in return for interest payments. Of course, the question can be raised whether any adjustment of the variable interest rate should be treated differently, because any increase or decrease in the variable rate is (theoretically) part of the expected risk which is included in the fixed interest rate of the loan amount granted to company B. However, I do not think that this is required: in the non-optimal scenario of a residence-based taxation of interest income it is consistent to tax any type of risk premium in state C and to allow for a reduction of the tax base for all types of actual risks related to the risk component. This is not only true for the risks related to the liquidity premium and the credit risk premium, but is equally true for an increase in the real interest rate and the inflation rate (and therefore an increase in the interest rate of the loan amount A-C). In turn, the actual amount of interest which is deducted from the tax base in state C should be taxed in state A as interest income. The same would be true, of course, in an alternative scenario where the loan amount A-C does not only encompass the (actual) basic interest component, but also risk elements. The latter elements would have to be taxed in state A.[89] Again, this is merely the consequence of a consistent application of the system of a residence-based taxation of interest income (non-optimal scenario). Thus, the following conclusions can be drawn from the alternatives above:

- the interest income should be taxed in the state in which the income is produced, namely in state B (optimal scenario);

- the income which is produced in state C, e.g. from asset management activities, should be taxed in state C (optimal scenario);

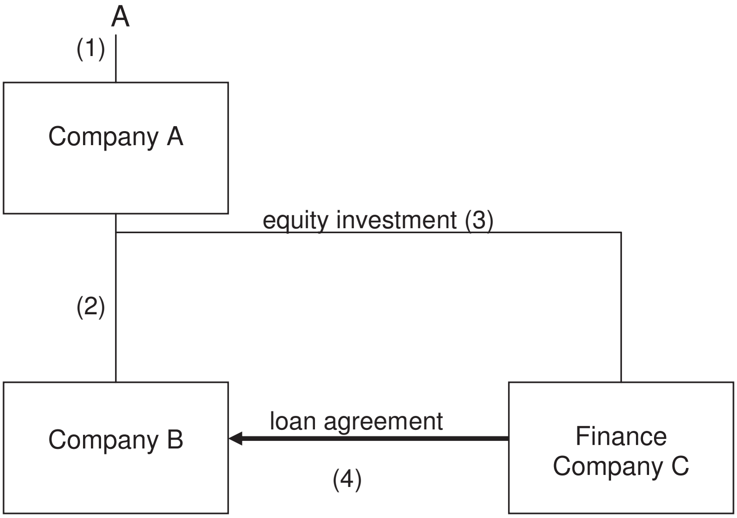
- in case of a residence-based taxation of interest income, the income spread in state C which is related to the taking over of the investment risks should be taxed in the state in which the risk is taken directly (state C). The same principle applies to a possible income spread included in the interest income of state A (non-optimal scenario);

- in case of a residence-based taxation of interest income, the basic interest component should be taxed in the residence state of the company which provides the capital in return for interest payments (non-optimal scenario).

The question arises whether the economic result should be different in a situation where company A does not grant a loan to company C but transfers the necessary amount in the form of equity.

[89] Which, however, is not the case in this example.

Figure 13:



Explanations:

(1) Individual A is the sole shareholder of company A.
(2) Direct investment of company A in country B through a subsidiary company. The business activities of company B encompass the manufacturing, the marketing and the distribution of goods in country B.
(3) Direct investment of company A in country C. The purpose of subsidiary C is limited to intra-group financing activities.
(4) Loan agreement between the companies C and B.

In this alternative, there is just an intra-group loan financing between companies C and B but not between companies A and C. In principle, the lender will not be able to achieve a higher interest rate compared to the aforementioned example. The whole amount of income is economically “created” in state B. A source-based taxation leads to the result that the income produced by company B is to be taxed in state B (optimal scenario). Nevertheless, it must be kept in mind that - in this situation - the strict source-based taxation is not the typical solution provided for in double tax conventions which are based on the OECD-MTC.[90] The majority of OECD-countries apply a residence-based taxation of interest income, even though sometimes accompanied by a withholding tax on the interest payments.[91] According to this common treaty practice, the total amount of interest income is taxed in the residence country of the finance company C and not in the source country B. The optimal result from an economic point of view cannot be achieved - in the same way as in the alternative above. The question could therefore be raised whether, in this non-optimal scenario, state A should have the equal right to tax part of the interest income or whether state C should have the preferred and exclusive right to tax the income received by the finance company.

[90] Article 11 (1) of the OECD-MTC.
[91] Article 11 (2) of the OECD-MTC.

However, one should be careful to avoid mixing up the result of intra-group legal structures with purely economic questions. Vogel pointed out that if it were correct that tax neutrality requires exclusive taxation of the profits derived by the country of the investment, then it would be non-neutral to deduct interest paid or deemed paid to the parent company or home enterprise from the gross income of the subsidiary or branch and to add it to the income of the head enterprise. The juridical cloak assigned to a transfer of money as debt rather than equity cannot change this economic reasoning.[92] However, if complete neutrality cannot be achieved, the focus must be - in my opinion and from an economic point of view - on competitiveness. Here we have an important difference between the residence-based taxation (without deferral of income) in general, and the limitation of a residence-based taxation to the amount which equals the basic interest component included in the respective income. The first form is a system which affects competitiveness in a - from my point of view - non-acceptable way since it leads to the outcome that the whole foreign income is taxed according to the tax system of the residence country and which therefore also comprises the functions and risks exercised abroad. If the taxation in the residence-country is significantly higher, the taxation will lead to a distortion of competitiveness and the group theoretically will pay for goods and services which were never provided. The second form concentrates the residence-based taxation on income solely derived from the use of capital. However, it is not the actual yield which can be derived by finance company C which matters here (otherwise it would be equally distorting competitiveness), but the yield which could be derived as a minimum compensation by utilising the existing capital.

Taking the aforementioned arguments into consideration, it can be said that safeguarding competitiveness is especially relevant in two situations. First, where an international company operates in a foreign market and has therefore to compete with local companies and subsidiaries of other multinational companies in the respective market and, second, where an international company separates and relocates functions and risks to other foreign companies. The latter is quite similar to the first situation but is basically related to the overall competitiveness on a group level. Therefore, I feel that the focus should clearly be on the safeguarding of competitiveness with respect to functions exercised and risks taken. In both cases it is important that the profits related to the functions and risks are not taxed more heavily in comparison to third party activities in the foreign market. The source-based taxation is a way to avoid that the companies pay for goods and services which were never provided.

If the outcome of a residence-based taxation (non-optimal scenario) is now compared to the outcome of a source-based taxation (optimal scenario), it is obvious that state B does not receive the share which is considered to be optimal from an economic perspective. In fact, the income which is taxable in state B can even be zero - in the absence of a withholding taxation or any other kind of source-based taxation (e.g. regular tax assessment). In contrast thereto, state C receives - pursuant to the non-optimal system of a residence based taxation - the taxing rights for the total amount of interest income. It is obvious, however, that the amount of interest income is not equal to the compensation for the exercise of functions and the taking over of risks. Of course, a minor part of the interest income might be seen - depending on the

[92] See Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (320).

alternative - as the coverage of functions carried out in state C, e.g. if an asset management activity is carried on in state C and if such an activity produces additional income in the latter state. But if this is not the case, the interest income encompasses the basic interest component and the risk component - which are both produced in state B. It is obvious from the previous conclusions that state C should receive the share which is related to the income produced and the risks taken in state C. The question can be raised, therefore, whether state C should have - in the absence of an optimal scenario - the exclusive right to tax the basic interest component. It is merely the legal structure and the allocation of taxing rights under the double tax convention concluded between states B and C which leads to the taxation of the total amount of interest income in the latter state. It is therefore legitimate and important to clarify whether there is any economic preference for an exclusive taxation of the basic interest component in state C or whether the basic interest component may also be taxed in state A. As already outlined above, if complete neutrality cannot be achieved, the focus must be on the safeguarding of competitiveness. Of course, the income which is produced in state C should not be taxed more heavily than the income produced by any other market participant in state C. The basic interest component, however, is not produced in state C but in state B. This is clear from the alternatives outlined above and this economic fact cannot be changed by the alternative legal structures. Consequently, the income-producing activity in state B should not be taxed more heavily than those of the competitors operating in the same market, either. It should therefore be clear that even in this non-optimal scenario of a residence-based taxation in state C - or alternatively state A - the tax burden related to the basic interest component should not exceed the overall tax burden theoretically levied on the income produced in state B. This is not the case with respect to the low-tax state C. However, in case of income taxation in the high-tax state A, the tax levied on the income produced in state B should theoretically be restricted to the comparable income tax rate applicable in the latter state. Otherwise, the international group of companies consisting of companies A, B and C would suffer a competitive disadvantage.

Of course, one could even go one step further and ask whether the lower taxation of the basic interest component in state C should be preferred, because it would lead to a lower taxation compared to countries A and B and therefore to a competitive advantage. However, one has to be very careful in this respect. If the starting point is the optimal result from an economic perspective, and it turns out that this would be a strict source-based taxation of the income produced in the respective countries, the question which *company* should be taxed is, in my opinion, only secondary. It is important to separate the income produced and to allocate the income to those *countries* where it is actually produced. In the alternatives above, the income is produced in country B (and in country C if an asset management activity is carried on). However, what is decisive in this respect is the fact that this economic allocation decision is, at the same time, a decision with respect to the applicable income tax rate. This is, of course, especially important from a competitiveness point of view. Again, the shifting of taxable income from state B to state C cannot be corrected in favour of state B (which would theoretically be necessary). In order to achieve the tax result on a group level which - in total - reflects the optimal result, the income portion of state B shifted to state C should not be taxed more heavily than in state B. However, whether the actual taxation is levied in state A or state C is not decisive since it cannot lead to the optimal result in either case. A competitive advantage which may be achieved through a lower taxation in state C exceeds what is - in terms of total tax burden - required by economic considerations in an optimal scenario. In my opinion, it could even be contrary to the aim pursued. The lower taxation could not only lead to an inefficient allocation of capital but would also lead to a competitive advantage which may be diametrical to the optimal economic solution - at least where the lower taxation also encompasses the basic interest component. In other words, if the income produced by a theoretical group of companies (group 1) is subject to a strict source-based taxation, the overall tax burden of a comparable group (group 2) which is subject to a non-optimal income taxation should not be subject to a considerably higher or lower overall taxation. Both situations, the higher and the lower overall taxation, would have a distorting effect on competitiveness. In essence, the fostering of a lower taxation would in this situation solely have the effect of safeguarding tax incentives and tax advantages.

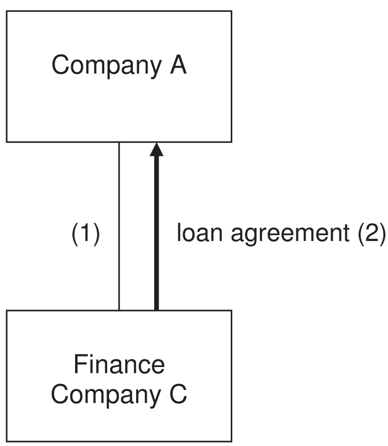
Thus, there is, in my opinion, no economic requirement for an exclusive taxation of the basic interest component in state C. As a consequence thereof, there is no economic necessity to refrain from taxing the basic interest component in state A. The decisive question is, however, whether the taxation of the basic interest component in state A should be limited to the percentage which was existent at the moment when the decision in favour of a fixed interest rate was taken (by company C) or whether any increase or decrease should be included in the tax base in state A, too. It was outlined earlier that the basic interest component is, in principle, to be determined on a rolling basis. However, the decision of company C for the acceptance of a fixed interest rate (instead of a variable interest rate) leads to additional risks assumed by the latter company. The reason is that the expected development is stipulated within the fixed interest rate - without any possibility for a further adjustment. It is therefore clear that any premium which compensates for the expected deviation from the existing basic interest component should be taxed in state C (in the absence of a taxation in state B).

On the other hand, the basic interest component is considered to be the component which can be achieved without taking investment risks, i.e. without the assumption of credit risks and without the necessity of stipulating elements which are solely based on expectations. From the perspective of state A it is therefore the actual basic interest rate - similar to the situation of the variable loan amount - which should be included in the domestic tax base. The fact that company C takes over additional risks should not lead to another outcome (at least not as long as the actual income is as high as the basic interest component - I will come to that aspect below). The reason is that company C provides services which contain a (theoretically) separable interest component and this component is not produced in state C. State A should therefore have the right, from an economic perspective, to tax the basic interest income *and* the increase or decrease over the period of investment.

One might argue that this results in a kind of “overlapping” of the taxation of the basic interest component and the risk component. However, in this respect it is important to note that any premium included in the (fixed) interest rate in order to cover such a risk is, in principle, only taxed in the state of the service company. The fact that any increase or decrease in the basic interest component is subject to current taxation in the state of the shareholder does not influence the taxation of the premium. Moreover, it has to be accepted that - with regard to the basic interest component - there are two different perspectives: the perspective of the state of the service company, where the expected increase or decrease has to be stipulated within the (fixed) interest rate, and the state of the shareholder which focuses on the taxation of the risk free component of the capital investment (minimum taxation). Both perspectives have to be recognised and accepted.

However, it is important to note that - in contrast to the example above - no inter-company loan relationship exists between company A and company C, and there is consequently no deduction of the interest payments from the tax base in the latter state. This requires the crediting of the taxes levied in state C on the basic interest income and theoretically even the reimbursement of exceeding taxes in order to avoid any double taxation. Depending on the situation, a possible withholding tax deducted in state B must also be taken into account in state A - to the extent that it has not been taken into consideration in state C. It is important, however, that the overall tax imposed on this income does not exceed the theoretical tax burden in state B. Moreover, such an approach requires that any income attribution is strictly limited to the actual amount of positive net income derived in state C. Any other approach would result in the taxation of income "which is not existent." For example, if 7 percent income is created in state B and transferred by way of interest payments to state C, but the expenses in the latter country exceed the 7 percent interest income, e.g. because of the actual risks related to the investment, no positive income is derived in state B and state C (in total). In this situation, no current taxation of the basic interest component should take place in state A. However, if the interest income of 7 percent results in a net profit in state C of 2 percent (e.g. because of the revaluation of the loan receivable or the interest receivable), the current taxation of the basic interest component should be limited to the remaining 2 percent positive net income - even if the basic interest component would be theoretically 4 percent.

Figure 14:



Explanations:

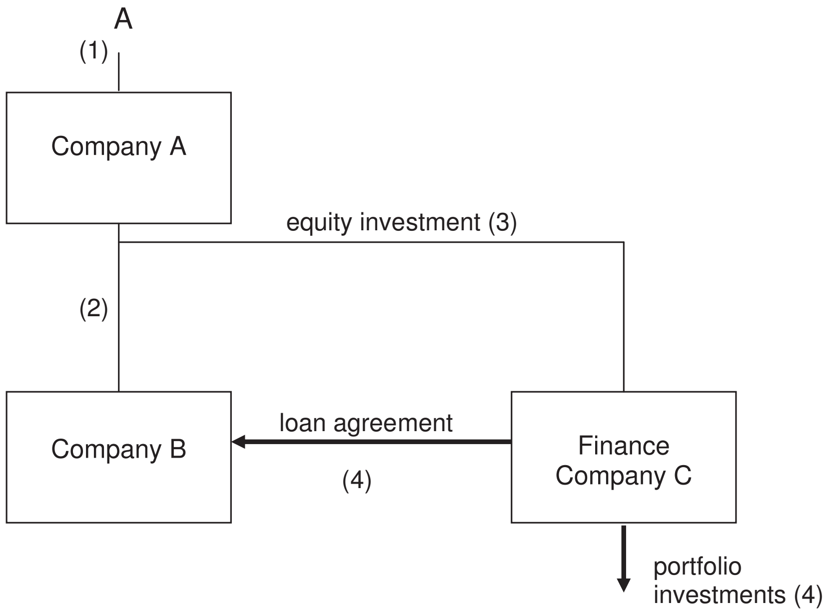
(1) Direct investment of company A in country C. The purpose of subsidiary C is limited to intra-group financing activities.
(2) Loan agreement between the companies C and A.

The situation of a finance company in state C which supports the business activities of company A is much clearer from an economic perspective and especially important in the context of this study. If the financial means are transferred as equity to company C which, in turn, transfers the amount back to the parent company A, the income should be taxed in state A. This, however, is only true to the extent that the income-producing activity is carried on in state A (and not in a third country). The taxation in state C must be limited to additional functions exercised which may lead to an additional value created in this state (e.g. cash pooling services, asset management services). This is completely in line with the general principles outlined earlier.

2.5.4.3. The Interest Component of Capital and Portfolio Activities

A similar situation exists where a company (company C) is interposed to invest liquid funds of the parent company A into the stock or bond market (portfolio investments) until the funds are needed within the group, i.e. a kind of cash management.

Figure 15:



Explanations:

(1) Individual A is the sole shareholder of holding company A.
(2) Direct investment of company A in country B through a subsidiary company. The business activities of company B encompass the manufacturing, the marketing and the distribution of goods in country B.
(3) Direct investment of company A in country C. The purpose of subsidiary C is the intra-group cash pooling and financing activities.
(4) Subsidiary C is responsible for portfolio investments (cash management) and the intra-group financing.

Similar to the example above, the residence-based taxation of interest income in country C - for example from listed bonds - is a non-optimal result from an economic point of view and I do not see any distortion of competitiveness where country A taxes the basic interest component on a current basis. In the same way as outlined above, the taxes imposed in country C and non-credited taxes imposed in third countries have to be taken into account. Equally to what was outlined above, a differentiation has to be made: In an optimal scenario the complete interest payment from listed bonds would have to be taxed in the country in which the income-producing activity is carried on. In a non-optimal scenario of a residence-based taxation in country C a separation of the tax base between country A and country C is required. The income related to the functions exercised and risks taken in country C is allocable to country C, e.g. the asset management activities themselves. This is based on the principles outlined above with respect to direct investments. The same is true for the risk elements included in the interest payments which are treated in a similar way. However, the basic interest component itself can equally be taxed in country A as long as the taxes imposed do not exceed the taxes which would theoretically be imposed in the source country in which the income-producing activity is carried on.

The situation with respect to portfolio dividends and capital gains realised by the disposal of portfolio investments in shares is different.[93] In contrast to interest income the general question arises whether dividends and capital gains should be taxed *at all*, i.e. whether taxation should be limited to a taxation of the company which produces the income.[94] If one follows the approach that the income should be taxed only once on the level of the company which produces the income, the subsequent taxation of the shareholder is - again - a non-optimal result from an economic point of view. As already outlined earlier, there are convincing arguments for a source-based taxation of portfolio income in general. However, a source-based taxation of dividends and capital gains does not mean that it is taxed on the level of the company which produces the income and subsequently again *by the source-state* (which is typically the same state). Any taxation in the aforementioned sense is to be seen as a strict limitation to a one-time taxation of the state where the income is produced, i.e. regularly the state of residence of the company or - in case of a permanent establishment - where the income producing activity is carried out.[95]

However, a different conclusion has to be drawn for the residence-based taxation of interest income compared to the residence-based taxation of dividends and capital gains. The interest income requires a one-time taxation which should preferably take place in the state in which the income is produced (optimal scenario). If this is not the case, the income related to the carrying out of functions and the assumption of risks should be taxed in the state of the finance company (non-optimal scenario). The basic interest component, however, may be taxed in state A. In case of dividends and capital gains, the underlying profit is already taxed in the source state. Economically, there is no room for any additional taxation in the residence state. That means, even

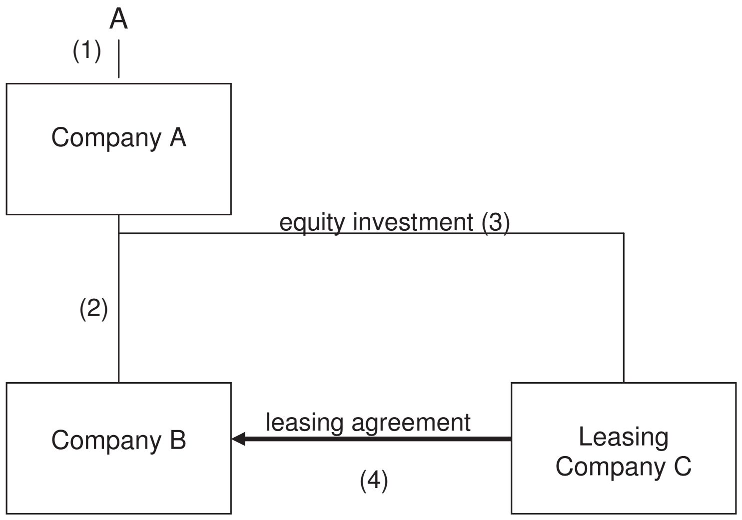
[93] The underlying assumption in this example is that the company in which the portfolio investment is made is an "active" company which exercises functions comparable to those of company B.
[94] The capital gain itself does not necessarily reflect the amount of retained profits. Depending on the prospects of the business it will often contain future profit elements, i.e. profits which will be produced in future periods and which can only be subject to a theoretical dividend payment in the future.
[95] However, this could be different when the corporate income tax rate for retained profits is below the "normal" tax rate and the full taxation only occurs when the earnings are distributed to the shareholders. If this is the case, the taxation takes place in two steps instead of a one-time taxation of the company.

if the finance company taxes the dividends and capital gains with a relatively low income tax, this will not justify any current taxation in state A. Even in case of portfolio investments in shares one could theoretically think about a basic interest component. However, in contrast to the interest income the taxation of the underlying business profits actually occurred "at the right place" from a competitiveness point of view, i.e. in the country where the business activities are carried on. This is true for the whole profit generated and there is - in my opinion - no room and no necessity to calculate any theoretical interest component in this situation.

2.5.4.4. The Interest Component of Capital and the Use of Tangible and Intangible Property

Another alternative could be that company C is not a finance company but has the function of a leasing company. In this scenario, the holding company A decides to increase the share capital of company C by 10 million Euro in order to enable company C to purchase a new and highly sophisticated machine which will be subsequently made available to company B by a leasing agreement.

Figure 16:



Explanations:

(1) Individual A is the sole shareholder of holding company A.
(2) Direct investment of company A in country B through a subsidiary company. The business activities of company B encompass the manufacturing, the marketing and the distribution of goods in country B.
(3) Direct investment of company A in country C. The purpose of subsidiary C is limited to intra-group leasing activities.
(4) Leasing agreement between the companies B and C.

Also in this case, company A does not receive any direct interest income from the investment. In general, and from the perspective of country A, the income received from the investment of 10 million Euro will not be taxed within its jurisdiction - at least not directly.[96] It is assumed that the terms of the leasing agreement between the companies B and C will be on an arm's length basis. The payments received by company C include all elements outlined above: a compensation for the write-off of the machine, a compensation for maintaining the machine, and a compensation for bearing the risk. Also included in the arm's length price is an interest component. The interest component covers the fact that a considerable amount of capital is invested by company C, with the financial means made available by company A. At the end of the day, the total profit derived from the business activities of company C will not only encompass the allocable profit according to the functions exercised by company C but also a profit which is due to the interest component.

From the perspective of company B, some additional functions are transferred to the service provider for a certain fee which is included in the leasing payments. The expenses of company B in relation to the leasing agreement should find expression, at least theoretically, in the sales prices determined by company B.[97] Again, the first three components should be taxed in country C where the leasing company carries out its activities, and the interest component should be taxed in the country where company B pursues its business activities. Similar to what was outlined with respect to the finance company this is most often not true where the double tax conventions are based on the OECD-MTC. Typically, the interest component is not separated from the aggregate income flows and the taxing right for the income received is allocable to the residence-state of the leasing company.[98] Therefore, what was described above with respect to the interest income of the finance company is equally true in this alternative.

2.6. Conclusions

1.) From an economic point of view, the basic question is whether the principle of capital export neutrality should prevail over the principle of capital import neutrality, i.e. the concept of efficiency over the argument of competitiveness, or vice versa. Based on what was outlined above, it can be concluded that the efficient allocation of capital is distorted by several factors and it seems to be obvious that complete neutrality cannot be achieved. Therefore, the principle of export neutrality not only fails to achieve complete neutrality but does also have a negative effect on competitiveness. In a world of globalisation and of different tax rates and tax systems it seems to me that the creation of an environment which clearly fosters competitiveness, i.e. a tax policy which allows companies to compete at equal terms in a respective market, would probably be the best and most realistic way to maximise global welfare. Such an environment can be achieved by following the principle of capital import neutrality and the application of a source-based taxation - in contrast to a residence-based taxation which reflects the principle of capital export

[96] Indirectly, country A could participate in the interest saved in country C either by higher dividend distributions or by an increase in the value of the shares in company C. However, this is only true under the assumption that the distribution and the subsequent disposal of shares is a taxable event in country A (and – in case of a tax credit – if the creditable tax in country C is not higher than the tax applied in country A).

[97] Of course, this is not always the case. Especially where the market is dominated by a great number of competitors and a relatively small number of potential customers. The question is whether the market actually allows the prices to be determined according to business management principles.

[98] The leasing activities are typically covered by Articles 5 and 7 of the OECD-MTC and royalty payments for the use of intangible property by Article 12 of the OECD-MTC. See in this respect also Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, pages 82 and 451 et seq.

neutrality. In general, this is not only true for foreign direct investments but also for portfolio investments.

2.) In my opinion, the safeguarding of competitiveness is especially relevant in two cases. First, where an international company operates in a foreign market and has therefore to compete with local companies and subsidiaries of other multinational enterprises and, second, where an international company separates and relocates functions and risks to other foreign companies. In both cases it is important that the profits related to those functions and risks are not taxed more heavily in comparison to third party activities in the respective foreign market.

3.) The latter case of a relocation of functions and risks may result in the establishing of services which are mainly based on the provision of capital such as financing services, leasing services, and licensing services. As a consequence thereof, inter-company income streams are created which include a separable interest component related to the capital provided and this interest component is one of the most important components of the overall compensation. For this reason, I consider the creation of capital-intensive inter-company services by allocating those functions and risks to separate legal entities to be a kind of "hybrid investment." It is called hybrid investment because it combines the elements of a *direct investment* - by incorporating a subsidiary (service) company in another state - and the elements of an *indirect investment (portfolio investment)* - by focusing on the provision of capital in return for (indirect) interest payments. In other words, such investments lead to a relocation of functions and risks which are mainly related to capital-intensive services - with a separable interest component - and which are utilised by another party, i.e. the capital is not *directly* employed for an income-producing activity of the subsidiary, but for an income-producing activity of the recipient of the services (which can be a related or unrelated party). The subsidiary, of course, realises income from the provision of capital, but not from the *direct* utilisation of capital in an income-producing process (of the subsidiary).

4.) Also in case of hybrid investments, the general conclusion should be that the interest income is to be taxed in the state in which the latter is produced. However, this is very often not the case, especially where the double tax convention between the state of the service company and the state of the recipient of the services is based on the OECD-MTC. In such a *non-optimal scenario* of a residence-based taxation the question arises whether all or part of the interest component included in the income should be taxed in the residence-state of the subsidiary (service) company or whether it could be equally taxed in the residence-state of the parent company. This question does not arise for additional functions exercised and risks taken by the respective parties. The income related thereto is clearly allocable - from an economic point of view - to the respective company which exercises the functions and which takes over the risks directly. The income which is related to the separable financing element, however, has to be split up into a basic interest component and a risk component.

5.) The basic interest component consists of the actual real interest rate and the actual inflation rate on a "rolling" basis, i.e. on the basis of permanent adjustments. In my opinion, the basic interest component is the minimum interest rate which can be achieved by an investor. It reflects a totally flexible investment which does not include any expectations and any risks related to the debtor and the time of investment. The basic interest component is strongly connected to the capital itself, even though it must be produced - just like any other income - by the recipient of the capital investment. Essentially, this component increases the wealth of the investor by the permanently adjusted real interest rate of a variable investment, because the inflation premium covers, in this situation, exactly the devaluation of money. In general, the basic interest component can be seen as an isolated component or as a component which is embedded in the total amount of interest income (together with the risk component).

6.) The risk component encompasses the elements which are based on *expectations*, e.g. the premium for an expected increase in the real interest rate and the expected increase in the inflation rate (in case of an investment which binds the investor for a certain period of time and where the interest rate is fixed). In case of an expected decrease in the latter elements, this may result in a reduction of the existing basic interest component (within the fixed interest rate). The risk component also includes the liquidity premium and the premium which is required to cover the risks related to the debtor. Theoretically, there should be a balance between the risks assumed by the investor and the compensation for those risks included in the interest income. The coverage of the risk does not necessarily require the direct connection to the capital investment, i.e. the risk coverage could theoretically be separated (or “stripped”) from the latter investment. This is particularly true for the risks which are related to the debtor, e.g. by way of a guarantee.

7.) Overall, it can be concluded that the interest income encompasses two very different types of components: the basic interest component, which can only be derived because of the provision of capital - and which is therefore strongly connected to the capital itself - and the risk component, which has to cover all of the potential risks which are caused by the debtor and the period of investment.

8.) The risk component included in the interest income is to be treated in the same way as other functions and risks and is therefore - in the non-optimal scenario - allocable to the company which takes over the risks directly and should therefore be taxed in the respective state. In contrast thereto, the basic interest component included in the income is strongly connected to the capital itself. Thus, there is no preference whatsoever for a taxation of the basic interest component in the residence state of the finance or leasing company from an economic point of view. The residence state of the shareholder (parent company) should therefore, from an economic perspective, have the right to currently tax the basic interest component. In the absence of a strict source-based taxation, the safeguarding of competitiveness requires that the overall tax burden does not exceed the result which would theoretically be achieved in an optimal economic scenario. The taxes imposed on the basic interest component should therefore be restricted to the theoretical tax burden in the income-producing state. Of course, the allocation of taxing rights deviates from the optimal economic scenario and this cannot be corrected. However, the overall tax burden on a *group level* - not on the level of the separate legal entity - would be comparable and would therefore not worsen the position of the group from a competitiveness perspective. In my opinion, there is no economic necessity to provide for a lower taxation of the basic interest component than the taxation in an optimal economic scenario of a source-based taxation. Such a lower taxation would even exceed what is actually required by the argument of competitiveness. One could even go one step further: the low-taxation on the level of an intermediate company in hybrid structures could have a distorting effect on the allocation of capital. In theory, this requires the basic interest income to be taxed in the hands of the low-tax company at a rate which is as high as the comparable tax rate in the source-country. If this is not the case, the higher taxation in the state of the parent company can have a positive effect with regard to the efficient allocation of capital and therefore also on competitiveness in general. However, this requires the limitation of the taxation of the basic interest component in the state of the parent company to the rate applicable in the source country. In addition, the state of the parent company has to provide for a crediting of the taxes levied on the income of the subsidiary company in order to avoid any double taxation. Thus, any taxation of the basic interest component in the state of the parent company may therefore be regarded as a partial and strictly limited application of the principle of capital export neutrality. However, such a current taxation in the state of the parent company - in addition to the taxation in the state of the intermediate service company - should not result in an “over-taxation” of income. For this reason, there should be a strict limitation to the actual income derived from the respective activities in the state of the intermediate service company (as a maximum). For example, if the (net) interest income from the financing activity of the service company is only 2 percent, e.g. because of the revaluation of the loan receivable or the interest receivable, the maximum amount of current taxation should be 2 percent - even if the basic interest component is 4 percent. If the activity results in a negative income, nothing should be allocated.

9.) The basic interest component should be taxed in the state of the shareholder (parent company) on a “rolling” basis, i.e. not just the basic interest rate which is applicable at the moment of making the investment (or the stipulation of a fixed interest rate) but also any subsequent increase or decrease. Of course, any subsequent development is part of the risk which is covered by the risk component and one might argue that this results in a kind of “overlapping” of the taxation of the basic interest component and the risk component. However, in this respect it is important to note that any premium included in the (fixed) interest rate in order to cover such a risk is, in principle, only taxed in the state of the service company. The fact that any increase or decrease in the basic interest component is subject to current taxation in the state of the shareholder does not influence the taxation of the premium. Moreover, it has to be accepted that - with regard to the basic interest component - there are two different perspectives: the perspective of the state of the service company, where the expected increase or decrease has to be stipulated within the (fixed) interest rate, and the state of the shareholder which focuses on the taxation of the risk free component of the capital investment (minimum taxation). Both perspectives have to be recognised and accepted. However, it is important, as already outlined above, that (i) the taxation in the state of the (subsidiary) service company and the state of the shareholder (parent company) is limited to the tax rate applicable in the state in which the interest income is produced and (ii) that any current taxation of the basic interest income is limited to the amount of actual income derived in the state of the (subsidiary) service company.

10.) It has to be emphasised that a distinction is to be made between functions where the interest component can be considered to be a separable part of the activity, e.g. finance and leasing activities, and functions where the interest component is only theoretically included in the overall economic output. In the latter case, the interest component is just a part of a - more or less - complex process of exercising a certain function. A theoretical separation of the interest component and a partial allocation to a parent company is therefore economically not justifiable and not required. The interest component in the latter case is a necessary element to “create” the services or produce a certain amount of income but it is not a separable part of the services itself. The portion of income which is theoretically related to the basic interest component is - in this particular case - produced in the state of the intermediate (service) company. In other words, the income produced by the exercising of functions should be taxed in the respective state. Any other solution would negatively influence competitiveness. This is irrespective of the “way” how the income is created and the elements which are necessary to produce the income.

11.) In case of portfolio dividends and capital gains of portfolio investments in shares the taxation should be limited to the taxation of the underlying profit realised by the foreign company which produces the income. Any deviating residence-based taxation of a foreign intermediate company does not justify a residence-based taxation of the shareholders in the intermediate company on a current basis. In contrast to interest income, the underlying income is already taxed in the source state and there should be no additional taxation in the residence state. In other words, even if the intermediate company taxes the dividends and capital gains with a relatively low income tax, this will not justify any additional taxation on a current basis. Moreover, the idea of a “basic interest component” does not play any role in this context. In contrast to the taxation of interest income the taxation of the underlying business profits actually occurred “at the right place” from a competitiveness point of view, i.e. in the country where the business activities are carried on. This is true for the whole profit generated and there is - in my opinion - no room and no necessity to calculate any theoretical basic interest component in this situation.

3. Legal Principles in International Taxation

3.1. Introduction

In this chapter the legal principle of equity will be outlined in the context of this study. It will be examined whether equity aspects require a residence-based taxation rather than a source-based taxation or vice versa. This will be done separately for direct investments, portfolio investments and the use of tangible and intangible assets. Moreover, the equity aspects and the conclusions drawn from the examination of direct and portfolio investments will be verified in the situation of a hybrid investment.

In addition, the general aspects of the OECD-MTC will be outlined briefly. This encompasses the question of international juridical and economic double taxation, the allocation of taxing rights according to the OECD-MTC, the methods of avoiding double taxation, and the outcome in case of a hybrid investment.

3.2. The Legal Principle of Equity

The question of how foreign income should be treated in comparison to domestic income and which state should have the right to tax certain amounts of income is strongly connected to the principle of equity. In general, the principle of equity can be divided into taxpayer equity and the so-called inter-nation equity.[1] Taxpayer equity requires the equal treatment of taxpayers in similar circumstances (horizontal equity) and concerns the taxation of persons in accordance with their ability to pay (vertical equity).[2] In contrast, inter-nation equity deals with the division of tax revenues among states instead of focusing on the individual taxpayer.[3]

3.2.1. Taxpayer Equity

3.2.1.1. Individual and Corporate Taxpayer Equity

A question which has to be answered in this context is the question whether taxpayer equity can only be relevant for individuals (individual equity) or whether there can be a kind of taxpayer equity on a corporate level (corporate equity). In this respect, it is sometimes referred to the difference between an integrated individual-corporate income tax system and a non-integrated system where the corporation is treated as a completely separate taxable entity. In an integrated individual-corporate income tax system, the corporation is viewed merely as a “conduit” for channelling investment income to the individual shareholder and the corporation income tax as a means of reaching retained earnings under the individual income tax,[4] or, as it is described by Arnold, a means for currently taxing the undistributed income of a corporation.[5] However, irrespective of the fact whether a state follows an integrated system or a

[1] Peggy B. Musgrave, United States Taxation of Foreign Investment Income, Issues and Arguments (1969), page 121 et seq.; Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (394).

[2] Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation (1986), page 52. The ability-to-pay principle will be discussed later on.

[3] Typically between states of source and states of residence.

[4] Peggy B. Musgrave, United States Taxation of Foreign Investment Income, Issues and Arguments (1969), pages 122 and 123.

[5] Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation (1986), page 53.

non-integrated system, it is likely that a state in both cases stipulates a dependency between the income taxation of a resident corporation and the income taxation of a resident shareholder. Of course, this is particularly clear in case of an imputation system where the tax rate of the individual shareholder is imposed on the profit distribution and the corporate income tax is credited against the income tax of the individual shareholder. But even in case of a classical system, the corporate income tax and the treatment of the distribution in the hands of the individual shareholders are not independent from each other, e.g. through the stipulation of an appropriate corporate income tax rate and, for example, the application of a half-income tax principle for subsequent profit distributions to individual shareholders. However, as long as the system provides for a treatment which considers the corporation as a separate taxpayer, there may be a possibility to take advantage from the fact that the "final" tax burden may be deferred through the retaining of income on the corporate level and the non-distribution of profits. Such an advantage may exist in case of investments in resident and non-resident corporations, because in both situations there can be a substantial difference between the income taxation of the corporation and the income taxation of the individual shareholder. Of course, the spread of tax rates can be increased by investing in corporations which are established in low-tax countries and tax havens. In the latter case, the interposition of a corporation may - in combination with the possibility of a deferral of domestic taxation - lead to significant advantages compared to an investment which is made without such interposition. This will be shown later on in more detail. However, if a comparison is required between resident taxpayers, it should either be limited to the comparison of individuals or the comparison of corporations, but should not be made between resident individuals and resident corporations. A comparison between resident individual taxpayers and resident corporate taxpayers can only lead to an appropriate result where the differences between the treatment of resident individuals and resident corporations are taken into account. It should be clear, however, that an approach which is restricted to the comparison of the treatment in the state of residence is not necessarily the approach which is to be preferred. This will be examined in the following.

3.2.1.2. Equality Aspects

Equality aspects encompass the relationship of taxpayers towards each other. It must be decided with whom the respective taxpayer should be treated equally. Is it the resident of a state who derives foreign income and who should be treated in the same way as his neighbour of the same state with domestic income, or is it the resident of a state who derives foreign income and who should be treated in the same way as a resident of the state from where he derives his foreign income and who derives domestic income from that state?

In a system of worldwide or residence-based taxation[6] the question is effectively resolved in a way that residents who are taxable on their worldwide income should be treated equally.[7] Residents with foreign income are therefore consequently treated in the same way as residents with domestic income. Similar to the discussion with respect to capital export neutrality and national neutrality there are different

[6] The same is true for the taxation based on citizenship, e.g. in case of the United States.
[7] See Peggy B. Musgrave, United States Taxation of Foreign Investment Income, Issues and Arguments (1969), page 122; Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation (1986), page 53.

approaches with respect to the treatment of foreign taxes. The proponents of international equity allow the crediting of the foreign taxes whereas the proponents of the national equity concept follow the principle that foreign taxes should be deducted as costs of doing business abroad. The reasons for rejecting the latter concept are similar to those outlined with respect to national neutrality. It is in my opinion an antiquated system which should not be followed in a world of ongoing globalisation.

In contrast, states which follow the principle of territoriality, and therefore a source-based taxation, focus on the equal treatment of income received by foreign and domestic investors within a certain market, i.e. equality with respect to the treatment of income irrespective of the place of residence of the investor. It was especially Vogel who pointed out that the taxpayer who receives income from foreign investment must be compared not only to the neighbours in his state of residence, but to his competitors in the state of investment, the source state, as well.[8] In cases where the tax rates are lower in the state of source than in the state of residence, taxation in the state of residence according to its higher tax rates destroys equality in the state of source. This is true even when the state of residence grants a credit for foreign taxes.[9] In addition, and based on the benefit theory,[10] it can be assumed that the state of source which applies a lower tax rate provides less public goods and services compared to the high tax state. This argument is therefore equally important for neutrality and equity considerations and cannot be put aside. A high level of public goods and services provided by the state requires a greater share of financial contributions which have to be borne by residents and non-residents which pursue an income-producing activity in that state, typically by paying a higher percentage of taxes on the respective income. Such a high level environment improves the working, living, and business conditions in that state and provides (directly or indirectly) the basis for receiving a higher income. At least, this should be true where public spending is efficient, i.e. where the degree of wasteful or unproductive spending is relatively low. In such a case, a resident or non-resident taxpayer with business activities only in that state would pay a relatively "fair share" for the public goods and

[8] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (396).
[9] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (396).
[10] In general, it has to be distinguished between the *benefit theory* and the *sacrifice theory*. Pursuant to the benefit theory, taxation should be related to the benefits received from publicly provided goods and services, i.e. a taxpayer who receives a greater number of public goods and services should make a greater contribution than a taxpayer who receives no or very few public goods and services. Since taxes are paid individually and public goods and services are provided collectively, taxation cannot be considered to be a direct consideration for public goods and services. However, according to Vogel it can be argued that taxes are a consideration paid for the totality of state services by all taxpayer taken together (see Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (395); see also Mill, Principles of Political Economy, Vol. 2, at 354 (1848); von Stein, Lehrbuch der Finanzwissenschaft, 5th edn., Zweiter Teil, Erste Abteilung (1885)). In contrast, the sacrifice theory is unrelated to any benefits received and requires the taxpayer to contribute equally to the community system of the respective state. However, the sacrifice theory is - in my opinion - not an appropriate approach in an international context. In my opinion, there is no convincing reason why the residence state of the individual taxpayer should have a preferred right of a "sacrifice" which prevails over the state in which - for example - a company is established. Theoretically, the latter state could derive claims which are based on any kind of "sacrifice," too. Vogel outlined that *"(...) the sacrifice theory, if it ever was an acceptable, is no longer acceptable today"* (see Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (394, 395); see also Vogel, Rechtfertigung der Steuern: eine vergessene Vorfrage, 25 Der Staat (1986), page 481 et seq.).

services received.[11] However, if the taxpayer derives nearly all of his income from activities carried out in a foreign country without using the domestic infrastructure and without receiving public goods and services in the residence country - but only goods and services in the source country to produce the foreign income - it is highly questionable whether the higher tax burden leads to the "appropriate" tax burden in the residence country. Similar to what was outlined above with respect to neutrality this approach would hamper the business activities of the taxpayer in the foreign country and would therefore strongly influence the competitiveness in the foreign market. And - what is important here - could hardly be considered an equal treatment of taxpayers. In effect, the taxpayer deriving foreign income would partly bear the tax burden which should be borne by other taxpayers who take advantage of the domestic infrastructure and the public goods and services. In other words, the public goods and services are financed by a source which does not receive and does not require any of the advantages provided - in the most extreme case. Of course, the resident individual will always receive goods and services in the residence country which are *unconnected* to the production of income but which are related to other aspects of life. The resident individual has therefore - without doubt - to contribute in one way or another to the system which provides those benefits. I will go into more detail below, where direct investment is discussed separately from other kinds of investment.

An argument which is closely connected to the aforementioned argument is that an investment in a foreign country with a lower taxation can be accompanied by a higher risk in the respective market, especially in developing countries. A higher risk connected to a particular investment requires a higher return on investment to balance out and cover the additional risk. A residence-based taxation has the effect that the (higher) profit which covers the increased risk is partly transferred to the residence country in the form of income tax. This could be acceptable to a certain degree where a loss incurred in the foreign market can be transferred to the residence country and can be offset with other - positive - income. However, in a situation where the foreign income encompasses the greatest part of the total income this is most often not the case. Even though it is true that the amount of public goods and services received as well as the degree of risk taken by the investor could also vary within a single country, a differentiation between those domestic differences and the differences related to foreign investment has to be made. The domestic differences - as described by Vogel - are incidental whereas those related to foreign investments are typical, and it is commonly acknowledged that equality may disregard differences that are incidental, but must take into account those that are typical.[12]

Moreover, Vogel puts forward another argument which refers to the difference between profits retained and reinvested in the foreign country and profits which are remitted to the residence country. The profits so reinvested remain connected to the foreign country and are therefore still subject to the higher risk. Of course, as long as the profits derived in the foreign market are reinvested in the foreign business activities the tax burden should be kept on the level of the foreign country. Vogel concluded that even if a case could be made on equality grounds for taxing certain

[11] It can only be "relatively fair." Taxes are paid individually and public goods and services are provided collectively - this can lead to distortions.
[12] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (396).

foreign income at the same rates as domestic income, this can be concluded convincingly only with regard to that part of the foreign income that has been repatriated to the state of residence.[13]

3.2.2. Inter-Nation Equity

Inter-nation equity deals with the question of how a certain amount of foreign income should be divided between the source country and the residence country, i.e. which country should have the right to tax all or part of the foreign income from an equity point of view.[14] If one follows the aforementioned benefit theory, it would make sense to take the benefits received in the respective countries into account.[15] That means, the countries involved should receive part of the allocable taxable profit based on the goods and services provided and actually received by the taxpayer in order to produce a certain amount of income. Of course, the benefit theory is open for criticism, especially in a domestic environment, since taxes are paid individually and public goods and services are provided collectively. In an international context, however, where – in the most extreme case – the income of a resident is produced only in the foreign state, the benefits received for the production of income in question are clearly allocable to the foreign state. What remains are the benefits received - typically for an individual taxpayer - with respect to all other aspects of life apart from the foreign business activities. In the following, equity considerations are verified separately according to the different types of investment.

3.2.3. Equity and Direct Investments

What is outlined above is of particular relevance for direct investments in foreign countries. In my opinion, there are basically six elements which can be distinguished and which are of importance in case of a foreign investment: (a.) the capital transfer from the residence country to the source country, (b.) the exercising of functions, (c.) the basic interest component of capital, (d.) the taking over of risks, (e.) the providing of a market to earn the income, and (f.) the redistribution of income to the residence country.

a.) The capital transfer from the residence country to the source country

A question which has to be answered in this context is whether the residence country has – from an equity point of view – the right to tax income which is related to the capital export from the residence country to the source country. Possible justifications for such a taxing right of the residence country could theoretically be derived from the fact that the capital is owned by a resident of that country or the fact that the capital is an accumulation of (after-tax) income earned in the residence country by the taxpayer himself or another person who is a resident of that country.[16] However, such

---

[13] Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (396).

[14] See in this respect Richard and Peggy Musgrave, Inter-Nation Equity, in: Essays in Honor of Carl S. Shoup, 1972, page 63; Flick, Die Begrenzung der Fiskalsouveränität, Internationale Wirtschafts-Briefe 1964, Fach 2, page 131.

[15] However, see with respect to benefits received also Peggy B. Musgrave, United States Taxation of Foreign Investment Income, Issues and Arguments (1969), pages 130, 131.

[16] In case the capital is transferred to the investor as a gift or by inheritance. According to Kemmeren, *"(…) capital lent out is, in principle, accumulated produced income not consumed or disposed of. If the capital was acquired through a gift, in a wide meaning, then the same reasoning is valid. The only difference is that such*

an argumentation indicates that an accumulated amount of (after-tax) income once earned in the country of residence remains connected to that country even if it is afterwards transferred and invested abroad.[17] I do not think that equity considerations require such a "permanent connection" in case the capital is actually invested abroad and produces totally new income based on that capital. Even though it seems to be obvious that the income would not be produced without the capital investment, this does not - by itself - provide an argument for a residence-based taxation of the total income and a permanent connection to the residence country.[18] In my opinion, there is no "original right" to tax the foreign income based on those arguments in general.[19] However, what should be considered in more detail below is the question whether a taxing right for the residence country can be derived from the concept of a basic interest component of capital.

b.) The exercising of functions

The exercising of functions related to the business activities usually demands the utilisation and the provision of public goods and services in the country where the activities are carried out. Therefore, it is typically the source country which provides most or all of the benefits which are relevant for the production of income. Without those benefits, the investor would not be able to produce the income in the respective source country.[20] As a consequence, it seems to be obvious that the country which offers those benefits, and in which the investor actually takes advantage of those benefits, should have the right to tax the income in question. Of course, the extent of how much benefits are actually utilised depends to a certain degree on the kind of business activity and the functions itself. However, this should not influence the general conclusion that the country in which the functions are exercised should have a preferred right to tax the income produced. The capital so invested in the source country is employed to exercise the respective functions which subsequently produce income or which will be part of a process which produces the income. It is clear that the functions exercised and the arm's length consideration - or profit which is allocable to those functions - do not necessarily correspond to the benefits received. Even though an allocation of the taxing rights which is based on the benefits received seems to be an appropriate formula, it would be difficult to measure and therefore hardly realisable. Therefore, an apportionment based on the functions exercised and arm's length considerations should be the underlying principle. In general, it can be assumed that complex functions are normally

capital will have been taxed in the pre-capital phase with another person than the beneficiary of the gift" (Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 433).

[17] The same is basically true for income earned through a foreign subsidiary which was subsequently distributed and accumulated in the residence country.

[18] *"(...) the legislature may choose either to tax income produced once and for all or to postpone part of its taxation and to make up for this later by taxing the returns on a reinvestment. If the legislature decides in favour of the first option, the taxpayer who paid the requisite taxes on his income is free to reinvest the after-tax balance abroad, and even to leave the country with all his wealth, without any claim to further taxation of his income from capital following him or his capital into the foreign country. (...) As a matter of fact, no state has ever chosen the second option"* and *"(t)o phrase it more generally, the fact that capital has been produced in a state is not a justification in and of itself for taxing the foreign proceeds of this capital* (Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (399, 400)).

[19] See in this respect also Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (398).

[20] See also Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (398).

accompanied by higher margins and typically require more benefits from the country in which they are exercised. In contrast, functions which are less substantial include lower margins and most often do not require the same extent of public goods and services. Even though this is a very general conclusion - and exceptions are likely - it seems to be a feasible possibility to divide the taxable income of business activities between different countries and to comply with the principle of equity. This requires, however, the strict application of the arm's length principle, i.e. it must be analysed how much profit is allocable to a certain function. Underlying information like payroll, property or other indices of economic activity can give an indication for the importance of the function in question, but they are not sufficient as an allocation key by themselves. In addition, it seems to be appropriate - also from an equity point of view - for a certain threshold to exist with respect to the activity in a certain country. Not every single temporary activity should lead to an allocation of profits but only activities which are exercised with a certain permanence. It seems to me that this could be very well in line with the idea of a permanent establishment as it is outlined in the OECD-MTC.[21]

c.) The basic interest component of capital

In principle, there are differences between capital intensive investments and non-capital intensive investments insofar as, *inter alia*, the first-mentioned investments theoretically require a higher portion of interest which must be included in the sales price of the products, the services rendered, or the profit allocable according to arm's length considerations (e.g. in case of a permanent establishment). This means an interest component should theoretically find expression in the determination of the value of functions exercised by, for example, a subsidiary company. This should lead to the conclusion that functions exercised by a certain number of personnel which are - from an intellectual perspective - comparable in case of a capital intensive activity and a non-capital intensive activity, are to be compensated differently. Based on the earlier conclusions - which will be further explained in the subsequent examples - one could raise the question whether there should be a difference in treatment between the income related to the exercising of functions (and the taking over of risks) in the state where the income-producing activity is carried on and the basic interest component. The latter component is connected to the capital itself and is theoretically also included in the income derived from these activities. In general, such a theoretical approach might only be based on the fact that a certain percentage of interest may be alternatively received - at any time - without taking additional risks. From the perspective of the residence state of the investor, it could be argued - based on the principle of equity - that even though the income-producing activity is carried on in the state of the subsidiary (the source state) a certain minimum percentage related to the capital invested should be allocable to the residence state. This would lead to an equal treatment of the basic interest income in the hands of the resident taxpayer which invests abroad and a resident taxpayer which invests in the residence state.

However, I do not think that this is the appropriate approach from an equity perspective. What is very important and should not be overlooked in all these considerations is the fact that the total income derived in the foreign country is derived from activities carried out in the foreign country - including the basic interest

[21] Article 5 and Article 7 of the OECD-MTC.

component. The income (including the basic interest component) must be actually produced, i.e. not a single component included in the income is existent just because of the fact that a certain amount of capital is invested. In a typical situation, the capital transferred to the source country as financial means will be transformed into tangible and intangible assets in order to exercise the functions and to carry out the business activities in the foreign country. The income so produced consists - in its totality - of values integrated into the economy of the source country and is subject to the source country's sovereignty.[22] This economic reality and the fact that the whole "new" income is produced in the source state should also be relevant from an equity point of view. In my opinion, these factors should prevail over the concept of a basic interest component, i.e. the basic interest component - which is theoretically included in the total amount of income received - should be taxed, under these circumstances, in the country in which the income is produced in order to comply with the principle of equity. Thus, an equal treatment of resident taxpayers in a way that the basic interest component included in the foreign investment and the domestic investment are both taxed in the state of residence is not in line with the principle of equity. This, however, might be slightly different in case of hybrid investments which will be outlined below in some detail.

d.) The taking over of risks

The taking over of risks can be relevant in different situations: it can relate to the risks involved in the exercising of a certain function, which is then a question of appropriate measuring and allocating profits to the respective function as outlined above, or it can relate - very generally - to the risks involved in the direct investment made in a particular market. A higher risk in the foreign market requires a higher profit derived in this particular market in order to compensate the risk, i.e. a profit which exceeds the purely functional margin of the activity. Especially in cases where the tax rate in the source country is lower than in the residence country it is important that the exceeding profit is subject to tax in the source country and not in the residence country. Any other solution would limit the possibility of the company to compensate for the increased market risk and would bring the investor into a position which is less advantageous in comparison to other market participants who are not subject to a residence-based taxation. Thus, it can be concluded that it is necessary from an equity perspective to tax the income related to the entrepreneurial risk and the market risk in the source country only. This leads to an equal treatment of foreign and domestic investments in the source state and avoids income being subject to taxation in the country of residence which might otherwise weaken the position of the foreign investor and reduce the possibility to compensate for those risks. In principle, the aforementioned strict limitation to a source-based taxation is not only required if the income taxation in the state of residence is higher than in the state of source, but is equally required if the income taxation is lower.

e.) The providing of a market to earn the income

The providing of a market has to be separated from the exercising of certain functions, e.g. sales functions. The exercising of a sales function and the respective profit related to such a function is to be taxed in the country where the function is

[22] See in this respect Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. (398).

exercised according to the principles outlined above. A completely different question is whether the providing of a market itself should give the country where the recipients of the sales and services are resident (the “sales country”) a right to tax part of the income received. Of course, the question is only of relevance if the sales country is different from the source country where the direct investment is made. Without doubt, the existence of a market to earn income is an important prerequisite for any successful business activity and it should also be clear that the goods and services provided by the sales country influence the market conditions and can increase the number of potential customers and clients. However, the supply of goods and services to customers in a foreign market does not require a permanent link to that country, i.e. the relevant business functions are exercised outside of the foreign market and the activities within the market are transitory or just auxiliary and preparatory activities. But even if a function is exercised within the foreign country which can be considered to be a permanent establishment, this will only lead to the result that the foreign country is granted a right to tax which is limited to the (arm’s length) profit related to the respective function and will not lead to a “compensation” for the providing of a market. However, in order to avoid mixing up the taxation of profits according to the functional allocation - which should be neutral - and any other approach which is not directed towards “a benefits received approach” with respect to the investment, but rather with respect to a more general “providing of a market,” I would rather consider another link to be more appropriate. Even though a taxing right for the sales country seems to be justifiable from an equity point of view, the (net) income earned within a certain market should not be the basis for taxation of the sales country.[23] In my opinion, a sales tax or a value added tax which is applicable to each single transaction is more appropriate than an income tax on the profits - applied by the sales country - which would only incidentally lead to a proper result.

(f) The redistribution of income to the residence country

Pursuant to the items listed above, it is quite obvious - from my point of view - that the taxation of the direct investment should take place solely in the country where the functions are exercised and the risks are taken as long as the income derived in the foreign country is reinvested and therefore retained in the source country. The situation can be different where the income is subsequently distributed to the residence country. The reason is that even though the resident individual does not receive any benefits from the residence country (or at least less benefits compared to the source country) he will nevertheless take advantage from the goods and services provided by the residence country which are *unconnected* to the production of income in order to produce the foreign source income. From an equality point of view it seems to be appropriate that the resident individual contributes part of his wealth to cover the costs for the public goods and services received in the residence country. One of the solutions typically provided is the taxation of the profit distribution.

However, in my opinion the income which is taxed in the source country based on the profits allocable according to the functional analysis should not be taxed again in the residence country - and I do not think that this is required by equity considerations. The focus should rather be on the subsequent use of the distributed income which can be, amongst others, the reinvestment of the financial means or the consumption. In the first case, the residence country would receive taxes from the newly produced

[23] Of course, apart from the taxation of the profits based on the functional analyses outlined above.

income if the financial means are invested domestically. In the second case, the residence country should participate in the consumption by levying a consumption tax. In other words: the resident individual should at least contribute to the costs of the infrastructure of the country which offers him the possibility to consume his wealth.[24] This seems to me the most appropriate way to cover the costs for the public goods and services received in the residence country which are *not* related to the production of income. This solution provides for an income taxation which takes into account the circumstances in the foreign country and a subsequent taxation of the consumption in the state where the investor is resident.[25]

3.2.4. Equity and Portfolio Investments

Even though the conclusions outlined above with respect to inter-nation equity and direct investments are generally also true for portfolio investments, the perspective is a bit different. In case of an investment in bonds - for example - the recipient of the benefits will be directly the debtor in the source country and only indirectly the investor (creditor) in the residence country. Similar to the conclusion that the business profits derived in the source country should be taxed in the source country, this applies equally to interest income. That means, the interest paid to the creditor should be taxed in the source state. The reason is that the income produced (which also comprises the interest in the first step) requires the providing of goods and services by the source country as described above. The subsequent interest payment to the creditor reduces the tax base of the debtor in the source country and if it does not - to the same extent - increase the tax base of the creditor in the source country (!), the latter country will consequently loose taxing rights which go beyond the allocable profit according to the principles outlined above with respect to direct investment. However, if the extent of benefits received for the production of income in the residence country is comparable in case of direct investments and portfolio investments, the result with respect to the allocation of taxing rights to the source country or the residence country should be the same. From the perspective of inter-nation equity, the taxing rights with respect to income from portfolio investments should be allocable to the source country in the same way as it is the case for income derived from direct investments.

With respect to taxpayer equity, it has to be taken into consideration that interest payments are actually transferred from the source country to the residence country. The situation is therefore different from an investment - for example in a foreign subsidiary - where the income received in the source country is reinvested and therefore remains connected to the higher risk in the foreign market. Here, the income is transferred to the creditor and - at the moment when the creditor receives the income - it is comparable to domestic portfolio investments. In addition, the portfolio investor is not in the same way integrated in the foreign country as the direct investor. Nevertheless, the interest paid to the resident investor from the foreign investment is in its totality dependent on the conditions which exist in the foreign market and only at the moment when it is actually transferred to the residence country the income becomes comparable to domestic income. Up to this point in time, the situation is different and I think that equality considerations therefore do not necessarily require the taxation in the residence country. This is especially true where both - taxpayer equity and inter-nation equity - are taken into account.

[24] Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 432.
[25] Of course, under the assumption that the income is consumed in the residence state.

3.2.5. Equity and the Use of Tangible and Intangible Property

As already outlined earlier in the context of neutrality, rental income and royalty income have to be subdivided into four different components: a compensation for write-offs of the property concerned, a compensation for maintaining the property, a compensation for bearing the risks, and an interest component.[26] Consequently, the principles just described with respect to direct and portfolio investments have to be applied. The first three components should be allocable to the country in which the leasing or renting activity is carried on.. In contrast thereto, the interest component should be allocable to the country in which the property is actually used for the income-producing activity. Of course, the separation may be difficult from a practical point of view. Pursuant to *Kemmeren*, a fixed part of the payments (percentage) could be classified as interest. This could be settled by protocol or mutual agreement between the two states or, alternatively, a standard could be included in the double tax convention.[27]

3.2.6. Equity and Hybrid Investments

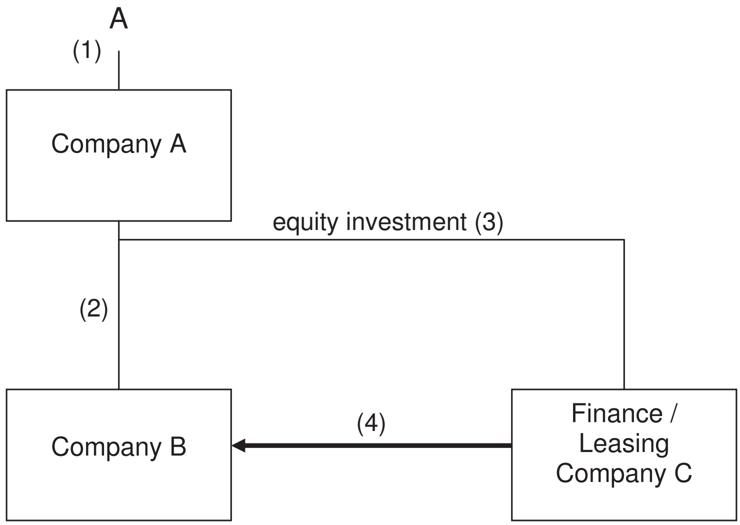
3.2.6.1. Finance, Leasing and Similar Activities

The conclusions outlined above with respect to direct and portfolio investments and the principles derived from those conclusions have to be applied to the so-called “hybrid investments.” As already described earlier with respect to neutrality, I consider the creation of capital intensive inter-company services by allocating those functions and risks to a separate legal entity as a hybrid investment, because it combines the elements of a direct investment with the elements of an indirect investment. A hybrid investment contains a separable interest component which, at the same time, is one of the most important components within the income of the respective entity.[28] The hybrid investments were of some importance in the context of competitiveness, and will be of similar importance with respect to equity considerations. The principle of equity clearly requires the taking into account of inter-company transactions where the legal structure provides a shifting of taxing rights from one country to another. For example, a foreign direct (equity) investment can be judged differently from a comparable investment where the capital (equity) stream is routed through a foreign finance company which is interposed in another (third) country. In the latter case, the capital stream is transformed within the legal structure into a debt stream. Even though the ultimate purpose of the investment remains the same, the separation and relocation of functions and risks to an additional entity and the outcome in terms of allocation of taxing rights cannot remain unconsidered for equity reasons. This can be explained best by the simplified inter-company structure which was already used in the previous chapter and which will be illustrated in the following. Even though the alternatives deal with finance and leasing companies, the

[26] Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 82. See also Vogel who subdivides the payments into three parts since he considers the compensation for maintaining the property and for bearing the risk to be one single part (see Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (318) and (Part III), Intertax 1988/11, page 393 et seq. (401).
[27] Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 453,
[28] The hybrid investments are outlined in chapter 2 in more detail.

principles regarding hybrid investments are equally relevant for any other rental and licensing activities related to tangible and intangible assets.[29]

Figure 1:



Explanations:

(1) Individual A is the sole shareholder of holding company A.
(2) Direct investment of company A in country B through a subsidiary company. The business activities of company B encompass the manufacturing, the marketing and the distribution of goods in country B.
(3) Direct investment of company A in country C. The purpose of subsidiary C is limited to intra-group cash pooling and financing activities (alternatively: leasing or renting out of tangible assets).
(4) Loan agreement (alternatively: leasing or rental agreement) between the companies B and C.

The situation in the example can basically be described as follows: Instead of limiting the foreign investment and the business activities to country B, the holding company A decided to split up the business activities and therefore the functions over two different countries and subsidiaries (whereas the main functions are exercised by company B) and to establish an intra-group debt financing between company C and company B (alternatively: a leasing or rental agreement). Of course, the underlying assumption in the example is that no abuse of law or similar legal aspects are involved according to which company C should not be considered to exercise the respective functions by itself.

Based on the equity considerations outlined above, the taxing rights for the income generated from the business activities of subsidiary B should be allocable to country B. The main reason is that the income-producing activity is carried on in country B

[29] However, the renting out of land and real estate is - based on the OECD-MTC - typically subject to a source-based taxation (Article 6 of the OECD-MTC). This, of course, reduces the problem. See in this respect also Schindel / Atchabahian, Source and residence: new configuration of their principles, General Report, IFA 2005, page 53 and the respective branch reports.

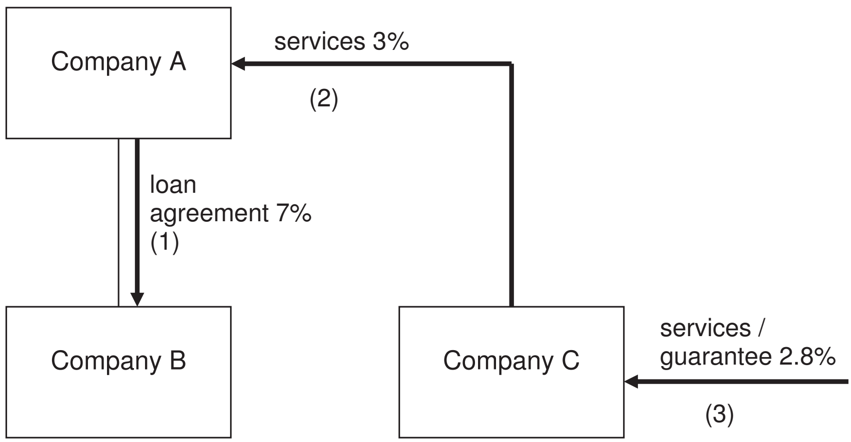
(and not in country A) and the activities are subject to the market risk of that country. It is therefore assumed that the public goods and services for producing the income are mainly or even solely provided by country B. The same should generally be true when the direct investment in the form of equity transfer is accompanied by a loan financing between company A and company B.

Nothing different should be true for the service functions exercised by company C. Even though the functions are less substantial and not comparable to those exercised by company B, they are part of the overall business activities of the group and therefore part of an income producing activity. The public benefits received for the exercising of these functions are less - compared to the functions exercised in country B - but certainly limited to country C. That means if the functions are only exercised in country C, the taxation of the income received should be restricted to the income taxation of country C. However, this result can only be true with respect to the service functions. As already outlined above, the interest income from the financing activity should generally be allocable to the country in which the income-producing activity is carried on. The same is basically true in an alternative scenario where the activity of company C comprises the leasing or renting out of tangible property with respect to the interest component included in the payments received. If this were the case, it would be in line with the general principles outlined above with respect to direct investments and portfolio investments.

The outcome is different, however, if the interest income (alternatively: the leasing and rental income) is subject to a residence-based taxation instead of a source-based taxation. In this case, the interest on the loan amount granted to company B (and the interest included in the leasing and rental payments) would be completely allocable to state C, i.e. the latter state has the right to tax the interest income. At least, this is the outcome for the interest income which is not separated from the leasing and rental payments if the double tax convention between countries B and C is based on the OECD-MTC.[30] For the interest income on the loan amount, the OECD-MTC theoretically provides for a limited taxation at source.[31] However, apart from the possibility of a limited taxation at source, the residence-based taxation leads to a deviation from the conclusions above and this might have consequences with respect to the principle of equity. The impact may be illustrated by the following examples.

[30] The leasing and renting out of movable property is qualified as business income and therefore taxable in the state in which the business activity is carried on (Article 7 of the OECD-MTC).
[31] Article 11 (2) of the OECD-MTC.

Figure 2:



Explanations:

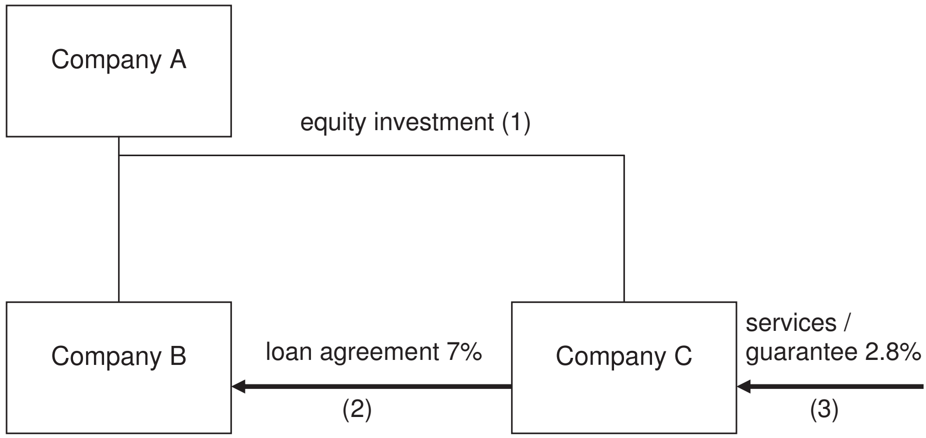
(1) Company A grants a loan amount to company B. The market interest rate is 7 percent.
(2) Company C provides services to company A which are related to the loan investment. This encompasses, *inter alia*, the provision of a guarantee for the repayment of the loan and a guarantee for the payment of the interest. For theoretical purposes, it shall be assumed that the guarantee prevents company A from any potential credit risk included in the loan agreement between companies A and B. Company A has to pay a yearly fee of 3 percent of the nominal amount of the loan for the services / guarantee provided by company C.
(3) The risks related to the loan amount and the interest payments are covered by a third party (re-insurance company). Company C has to pay a yearly fee of 2.8 percent of the nominal amount of the loan for the third party guarantee. It shall be assumed that the guarantee completely eliminates the credit risk, i.e. the financial standing of the ultimate guarantor (re-insurance company) is to be considered extraordinarily good.

In this alternative, company A wants to achieve a stable and continuous interest income without taking substantial risks. In fact, the contractual arrangements eliminate the risk related to the borrower (credit risk) which is now shifted to company C (and indirectly to the re-insurance company). If the loan amount is structured as a non-flexible investment with a fixed interest rate, the remaining risk is influenced by the investment period. If it is just a short-term loan, the risk is relatively moderate and encompasses the risk that the *actual* development deviates form the *expected* development of the real interest rate and the inflation rate. Of course, the longer the period of investment, the higher the risk of a deviation between the actual rates and the expected rates. In contrast thereto, if the loan amount is structured as a completely flexible investment with a variable interest rate which is permanently adjusted - depending on the development of the real interest rate and the inflation rate - the net interest income should encompass the *actual* real interest rate and the *actual* inflation rate (the basic interest component).[32] In this situation, the investment can - under the given circumstances - be considered a risk-free investment. It is also clear from the explanations that all services in relation to the investment are provided

[32] It is unlikely that investor A would accept an amount of net interest income which is lower than the basic interest component (as defined in chapter 2).

by company C. Taking into account a residence-based taxation in countries A and C, the interest income of 7 percent minus the service fees (including the fees for the guarantee) of 3 percent will be subject to tax in country A, i.e. 4 percent of the nominal amount of loan investment per year. If the double tax convention between the countries A and B is based on the OECD-MTC, a limited taxation at source is provided for in country B. The service company C derives income from the rendering of services to company A of 3 percent and has to pay fees for the re-insurance of the credit risk of 2.8 percent. The net income which is subject to tax in state C is 0.2 percent. The latter percentage reflects the net income which covers the service functions and the risks inherent in the activity of company C. Overall, the residence-based taxation leads to the result that, depending on the alternative, an amount which is at least as high as the basic interest component is taxed in state A and the service income of company C is taxed in state C. In case of a withholding taxation in state B, a tax credit has to be granted in state A in order to avoid a possible double taxation of income. The tax treatment of the re-insurance company as well as other theoretical tax risks related to the structure will be excluded from the examination.

Figure 3:



Explanations:

(1) Direct investment of company A in country C.
(2) Company C grants a loan amount to company B. The market interest rate is 7 percent.
(3) The risks related to the loan amount and the interest payments are covered by a third party (re-insurance company). Company C has to pay a yearly fee of 2.8 percent of the nominal amount of the loan for the third party guarantee. It shall be assumed that the guarantee completely eliminates the credit risk, i.e. the financial standing of the ultimate guarantor (re-insurance company) is to be considered extraordinarily good.

The example is now slightly amended. Instead of granting the loan directly to company B, the parent company A chooses to increase the share capital of the service company C which, in turn, transfers the financial means to company B. Legally, company C does not act as the service provider for company A anymore but as the provider of the loan amount to company B. Economically the functions exercised by company C are not substantially different from the alternative above (preparation and finalisation of all steps necessary for the investment - including the third party re-insurance). Furthermore, it can be assumed that company C does not require more benefits from the state in which the company carries on its activities than in the example above. It is just the decision of company A to increase the share capital of company C instead of granting the loan directly to company B. It shall be assumed that the provision of the loan is not to be considered more burdensome than the increase in the share capital, and vice versa. However, a residence-based taxation in the states A and C leads to a different outcome regarding the income derived in this structure. In contrast to the situation above, the residence state of the parent company A is not in a position to tax the interest income. Instead, it is state C which taxes the complete amount of income, i.e. 4.2 percent (7 percent interest income minus 2.8 percent fees for the guarantee). Thus, the income does not only encompass the 0.2 percent spread which covers the functions exercised in relation to the investment and the guarantee but also the complete amount of interest which was originally allocable to the state of the parent company A. In other words, the slight amendment of the structure leads to the outcome that the taxing rights related to the interest income are transferred from state A to state C.

It should be clarified whether the decision of company A to invest in the share capital of company C leads to a substantial difference in comparison to the loan investment in company B. In case of the loan investment, company A is in a position to derive 4 percent interest income on a yearly basis and an additional income from the equity investment in the service company C of 0.2 percent through subsequent profit distributions and / or capital gains from the disposal of the shares (if the profit is not distributed or not completely distributed).[33] In contrast thereto, the mere equity investment does not provide for a permanent interest income. However, the profit realised by company C encompasses the original spread of 0.2 percent plus the interest income of 4 percent. In total, the profit derived by company C includes both components and is theoretically available for subsequent dividend distributions and / or increases the value of the participation and therefore the potential capital gains from the disposal of the shares (if the profit is not distributed or not completely distributed).[34] Leaving aside the corporate income tax, the same amount of income is available either through a combination of interest income and dividends (and / or capital gains) or solely through dividends (and / or capital gains). A possible withholding tax on the interest income would be deducted in both cases, i.e. from the interest payments to company A or the interest payments to company C. In the first case, the withholding tax has to be credited against the corporate income tax in state A and in the second case against the corporate income tax in state C. In both cases, it will not have a direct or indirect negative effect on company A (under the assumption that the withholding tax is lower than the corporate income tax in the states A and C).

As already mentioned above, if the functions carried out by companies A and C in the first alternative are compared to the functions carried out by companies A and C in the second alternative, it seems that the changes are not significant from an economic point of view. In the first alternative, the activity of company A was

[33] The corporate income tax imposed on the 0.2 percent income in country C has to be taken into account and will therefore reduce the amount which is available for distribution and the potential capital gains, respectively.
[34] The corporate income tax imposed on the 4.2 percent income in country C has to be taken into account and will therefore reduce the amount which is available for distribution and the potential capital gains, respectively.

restricted to the (mere) provision of a loan amount to company B.[35] Company C (by way of services provided to company A) carried out all activities which are related to the loan amount granted from company A to company B (e.g. the arranging of the re-insurance). In the second alternative, company A did not grant the loan (directly) to company B, but instead increased the equity in company C. The activities of company C are now carried out in the context of its "own" financing activities and no longer in the context of services provided to company A. However, the functions carried out by the personnel of company C in the second alternative are almost the same as in the first alternative.[36] That means the personnel of company C will, to a large extent, carry out the same activities, the infrastructure might be identical or almost identical and the service providers which are required in the context of the activity will be the same or almost the same (e.g. legal services, re-insurance company). The significant increase in the income of company C in the second alternative can therefore, in my opinion, not be explained by an increase in the economic output created by the personnel in state C, because this is not the case. Moreover, the benefits received from state C should be identical or almost identical and therefore cannot "justify" the significant increase in the income tax base in state C, either. In fact, it is the interest income related to the loan amount which is responsible for the increased income of company C and the increased tax base in state C. The decisive question is whether there is a significant risk transfer from company A to company C (and from state A to state C) which explains (and "justifies") the increase in income which can be taxed in state C.

In order to examine the risk transfer to state C it can be useful to make a differentiation between the situation where the loan agreement is a non-flexible agreement with a fixed interest rate, on the one hand, and the situation where the loan agreement is a completely flexible agreement (repayable at any time) with a variable interest rate, on the other hand. In the first situation - and based on the conclusions drawn in the previous chapter - the interest income should encompass the following elements:

- the (credit) risk premium (which, however, is covered by the guarantee);
- the liquidity premium (only in case the loan amount is not provided on a short-term basis);
- the *expected* deviation in real interest rate and inflation rate over the period of investment;
- the basic interest component (as defined in the previous chapter);

The first three elements are clearly risk elements. However, due to the fact that the credit risk is covered by the guarantee, only the risks which are related to the period of investment (liquidity risk, expected deviation in real interest rate and inflation rate)

[35] The examination just focuses on the loan amount and the activities in this context. Company A may, of course, carry out additional functions which, however, do not play a role in this example. The same is basically true for company C.

[36] It is "almost" identical because there will be, in any event, small differences which are caused by the change of the activity from a provider of services to company A towards a provider of loan amounts to company B. For example, there will be no invoicing of services anymore to company A, the re-insurance agreement will be concluded directly with company C instead of company A et cetera.

might directly influence the income of company C. That means any misjudgement of the future situation by company C, e.g. with respect to the development of the real interest rate, the development of the inflation rate, or the disposability of the loan amount granted to company B, can have positive or negative consequences for company C. It is obvious that the assumption of risks requires - from an equity perspective - that the respective premium is subject to taxation in state C if it cannot be taxed - based on the double tax conventions concluded - in state B. This would result in a balance between taxing the positive risk premium and taking into account the (possible) negative effects of such an assumption of risks. However, as already outlined in chapter 2, the basic interest component - at the time when the investment decision is made - is not part of the risk balance. Instead, the latter component reflects the *existing* real interest rate and the *existing* inflation rate. I have already made it clear that, in my opinion, both elements can be derived without taking any risk and without making any estimation with respect to the future development of those elements. Theoretically, company C has the possibility to derive the basic interest income as a separate component (on a rolling basis) or, alternatively, as a component which is included in the loan amount granted to company B. In the latter case, the basic interest component becomes part of a fixed interest rate (increased or decreased by an amount which reflects the expectation of the future development).

In the alternative scenario of a completely flexible loan agreement - combined with a variable interest rate - the situation is different: the total interest rate neither includes a liquidity premium nor a premium which covers the expected development of the real interest rate and the inflation rate, because it shall be assumed that the interest rate will be permanently adjusted in order to reflect any increase or decrease in the latter elements. However, since the credit risk is covered by the guarantee, the interest income can be identical to the basic interest component (if the premium for the third party guarantee as well as the element which is related to functions carried out by company C are eliminated).

If the non-flexible agreement is compared to the flexible agreement, it seems that it is the stipulation of the liquidity premium and the stipulation of the expected deviation in real interest rate and inflation rate which makes the difference - and which might have consequences for the investor who makes the decision. For example, if the inflation rate was expected to be constant and it turns out that the inflation rate has been increased dramatically over the period of investment, the interest rate (in a non-flexible agreement) was effectively too low. This, of course, has a negative impact on the wealth of the investor. The provision of a flexible loan amount has no comparable consequences. Clearly, even the provision of a loan amount which effectively reflects the basic interest component requires a decision. However, if the decision is made in favour of the basic interest component (only), the investor can derive an income component which does not entail any risks. Of course, the investor may lose the possibility to derive higher income (by accepting risks), but this does not really matter for the conclusion. What is important is the fact that the investor - be it company A or company C - may derive a (minimum) compensation without the involvement of risks. If the investor wants to earn more than the basic interest component, a decision has to be made which requires the taking over of risks (and / or the carrying out of additional functions). The non-flexible agreement is therefore - in contrast to the flexible agreement - a combination of risk-free elements and risk elements. The deriving of the basic interest component may be restricted, in the latter situation, by the assumption of risks. However, it is obvious that the basic interest component is a component which, by itself, does not require the carrying out of functions in state A or state C (but in state B) and which cannot be seen as a compensation for the assumption of risks in state A or state C. This, of course, is of importance from an equity perspective.

If the alternative in which the loan amount is provided by company A (first alternative) is compared to the alternative in which the loan amount is provided by company C (second alternative), it becomes obvious that the second alternative can be considered a kind of “worst case scenario” for state A. In contrast to the first alternative, where 4 percent interest income can be taxed on a yearly basis (taking into account a possible withholding tax deducted in state B), the outcome of the second alternative depends on the treatment of dividends and capital gains in state A. If the dividends of company C or a possible capital gain realised are exempt from taxation, state A will not be in a position to end up with a comparable tax result, i.e. state A will actually lose 4 percent income on the nominal amount of investment as a taxable result (minus the impact of a withholding tax credit) on a domestic corporate level. However, even if the dividends of company C or a possible capital gain are subject to tax in state A, the outcome is by no means comparable to the first alternative. For example, if state A provides for the elimination of a double taxation by way of a tax credit, the corporate income tax imposed by state A will be reduced by the corporate income tax of state C. If it is assumed that the corporate income tax in state C is comparable to the corporate income tax of state A, nothing will be gained, i.e. the additional corporate income tax might be zero. If state C is a low-tax country - and this is rather likely in this structure and is generally assumed in the examples - the result is mainly influenced by the period of time between the realisation of the income in state C and the distribution to state A (respectively disposal of shares). The effect which is commonly known as “deferral” is outlined in some more detail in the following chapters. However, what is absolutely clear is that the deferral of the domestic taxation of foreign income may have a similar effect as the exemption of income taxation. The longer the period of deferral, the higher the theoretical discount on the future income taxation in state A. Thus, it can be concluded that the second alternative may have a disastrous effect on the tax balance of state A without gaining anything in exchange. Of course, one could argue that an alternative equity investment in state B (instead of a loan investment) would have a similar impact on the tax balance of state A. However, it is quite obvious that an equity investment in state B is totally different from the second alternative. In such a case, the non-existence of interest payments will increase the income of company B in state B. The taxation in state B is exactly the result which is considered an optimal scenario from an economic perspective and from a legal perspective, whereas the second alternative is only optimal to the extent that it is related to the 0.2 percent of the nominal amount of investment.

The perspective of state A is of particular importance in the context of this study. The decisive question from an equity perspective is therefore whether state A should have the right to tax the income which is - pursuant to the structure in the second alternative - allocable to state C. In my opinion, the income which is related to the functions exercised and the risks taken in the latter state should not be attributable to state A on a current basis, neither in the first nor in the second alternative. Thus, it is clear is that the 0.2 percent of the nominal amount of investment should not be subject to tax in state A - because the 0.2 percent are directly related to the carrying out of functions in state C. In my opinion, equality aspects require that a resident of state A who derives foreign income from state B should not be taxed more heavily than a resident of state B who derives domestic income from that state. The same is, of course, true for the relationship between states A and C, i.e. a resident of state A who derives foreign income from state C should not be taxed more heavily than a resident of state C who derives income from the latter state. In my opinion, if one follows the benefit theory, no other conclusion is possible than to concentrate on the state in which the income-producing activity is actually carried on, no matter how many states are legally interposed in the transaction. An interposition may only be relevant to the extent that additional income is produced in this state. Unfortunately, a residence-based taxation does not lead to such a result.

Thus, the conclusion in a non-optimal scenario should be - in my opinion - to tax the 0.2 percent in state C only (as outlined above). The taxation of the difference of 4 percent depends on the respective scenario: if the amount encompasses any risk elements (e.g. in case of a non-flexible investment), the risk elements should be taxed in state C and not in state A. However, this requires that any negative income which is created by the assumption of losses through company C is taken into account in state C, too. The basic interest component is unconnected to any functions carried out in state A and state C and is also unconnected to any risks assumed in state A and state C. Based on the rules of allocating taxing rights between the states involved, it is quite simple to transfer the right to tax the basic interest component from one state to another. If the allocation of taxing rights follows the principles stipulated in the OECD-MTC, the basic interest component simply follows the transfer of functions and / or the transfer of risks to state C. This, however, is the decisive point: why should state A forgive the possibility to tax the basic interest component just because of the fact that functions and risks (and the respective income) - which are not directly related to the basic interest component - are transferred to another state?

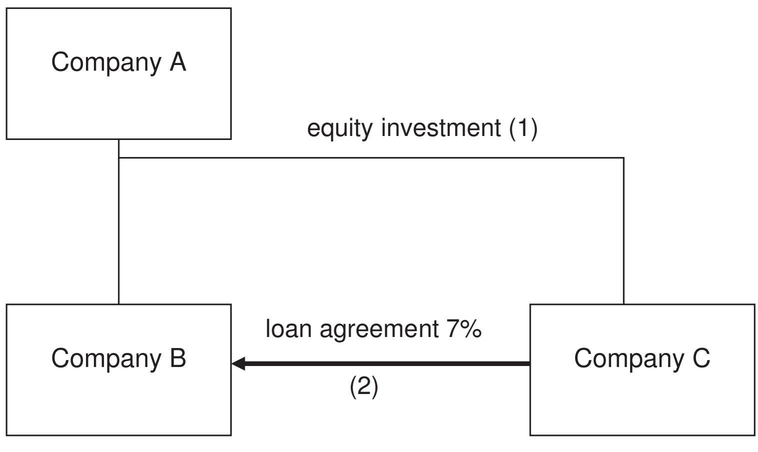
One has to keep in mind that - in contrast to a direct investment in state B - the financing through company C allows the (theoretical) subdivision of the elements included in the interest income. Of course, if the actual risks exceed the premium stipulated in the total interest rate, this will also affect the basic interest component (and might even affect the principal amount of investment). But this is not the decisive point: the risk component - and *not* the basic interest component - shall cover the risks involved. Therefore, if state A does not tax the basic interest component in the first alternative *and* the second alternative, it might foster the interposition of companies in low-tax states to shelter such income from domestic taxation (in state A) without supporting the optimal economic result. This, however, would definitely not be in line with the principle of equity.[37] Again, it is obvious that such an approach is far from an optimal scenario of a strict source-based taxation, but it is - in my opinion - the most preferable result within a structure where residence-based taxation prevails. In other words, the basic interest component should be subject to income taxation in state A and the risk elements (credit risk premium, liquidity premium, the expected deviation in real interest rate and inflation rate) should be subject to income taxation in state C (if they cannot be taxed in state B).

[37] See in this respect also Schindel / Atchabahian, Source and residence: new configuration of their principles, General Report, IFA 2005, pages 44, 45.

In general, the question whether the basic interest component should be taxed on a "rolling" basis also arises in the context of the principle of equity. In my opinion, the aspects which have been outlined in the previous chapter are equally relevant from an equity point of view. Therefore, chapter 2 can be referred to in this regard. The basic interest component is to be seen as the risk-free (minimum) income which can be derived by the shareholder and it is therefore an acceptable and preferable approach to tax this income on a rolling basis instead of focusing on any fixed rate.

Theoretically, there can be several possibilities to ensure the taxation in state A. One possibility could be the implementation of tax accounting rules which focus on the yearly revaluation of the investment in company C ("mark-to-market"). This, however, would lead to an income taxation which is not (necessarily) identical to the basic interest component. Another possibility might be the taxation of subsequent dividends (instead of an exemption). But such an approach does not solve the problem of deferral. In my opinion, the approach which should be preferred is the current taxation of the basic interest component in state A on a yearly basis. It is clear, however, that any approach for a current taxation of the basic interest component must provide for a complete elimination of double taxation of income and should theoretically be limited to a comparable taxation in state B. This should not only be true for the (direct) interest income from the loan agreement between company A and company B, but should be equally true for any current taxation of income in state A (I will go into more detail of that aspect below). Moreover, it should also be clear that any current attribution of income is to be limited (as a maximum) to the positive income derived by the intermediate company. As a general rule, the current taxation must not result in the taxation of income which is not existent on the intermediate level. The principles outlined in the previous chapter are equally relevant in this context.

Figure 4:



Explanations:

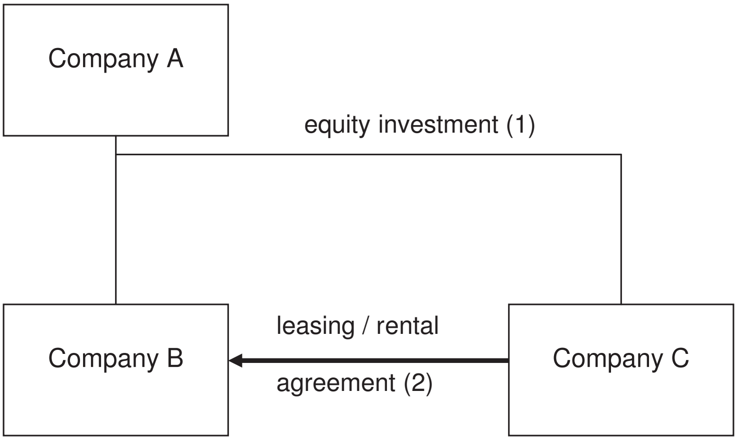
(1) Direct investment of company A in country C.

(2) Company C grants a loan amount to company B. The market interest rate is 7 percent. The credit risk related to company B is directly covered by company C (no re-insurance contract is concluded with a third party).

The credit risk is now completely borne by company C itself and not by the re-insurance company. The additional income of 2.8 percent of the nominal amount of investment is the compensation for the risk related to the borrower and a portion which was originally included as a profit element of the re-insurance company. That means if the borrower is unable to repay all (or part) of the inter-company loan, company C has to write-off the loan granted to company B. If it is assumed that the credit risk premium included in the interest payment covers exactly the risk involved, there is no necessity to currently tax this portion of income in country A.[38] However, it should be clear that a possible write-off of the loan amount must, in turn, be deductible from the tax base in state C. Any current taxation in state A would systematically require a possible loss related to the loan amount to be deductible from the domestic tax base in state A on a current basis, too. This, however, is often not the case. Again, I do not see the necessity to tax the 2.8 percent in state A since it is related to a risk directly taken over by company C. The same is true for any other risk element included in the amount of interest (liquidity premium, expected deviation in real interest rate and inflation rate). Again, it must be underlined that this is the preferred solution within a non-optimal situation of a residence-based taxation. Only under these circumstances can the taking over of risks be compared to the exercising of regular business functions where the appropriate compensation covers not only the actual expenses but also the risks related to the activity. It is absolutely clear that the income which is related to the risk component is economically created in country B. In an alternative scenario, where the loan is granted directly from company A to company B (without the guarantee), the risk component would fulfil the same purpose. It would, *inter alia*, cover the risk of writing-off the loan amount and therefore the risk of a direct impact on the domestic tax base of company A. Very generally, it can be concluded that in the non-optimal scenario of a residence-based taxation the amount of income which is neither a compensation for the exercising of a certain function nor a compensation for a risk taken in the respective state should be taxed in the state of the parent company A. Any limitation to an income taxation on an intermediate level would not be in line with the principle of equity. This will be shown in more detail below. In other words, what remains taxable in the residence-state of the parent company is an interest amount which can be derived without taking any additional risks.

[38] The same is true for the small profit element which is theoretically included in the (original) activities of the re-insurance company and which is now included in the income of company C.

Figure 5:



Explanations:

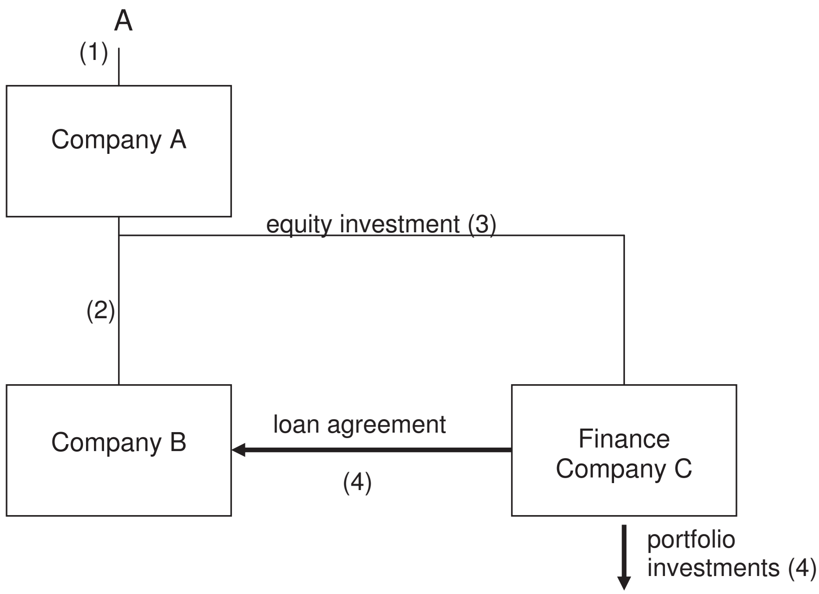
(1) Direct investment of company A in country C.
(2) Company C provides leasing / rental services to company B. The movable assets are employed for an income-producing activity in country B.

In principle, the aforementioned aspects equally apply to the leasing and rental services carried on in state C and provided to company B. Clearly, the leasing and rental activities are more complex than the simple provision of loan amounts, but the conclusion regarding the interest income included as a part of the leasing and rental income remains the same. The compensation for the write-off of the asset, the compensation for maintaining the asset, and the compensation for bearing the risk are allocable to the state in which the leasing and rental activities are carried on. In this respect, the economic conclusion is fully in line with the conclusions regarding the principle of equity. The interest income should theoretically be allocable to state B. However, in the non-optimal scenario of a residence-based taxation the interest income is subject to tax in state C, i.e. the state in which the leasing activity is carried on. In contrast to the example of a finance company, the OECD-MTC does not provide for a limited taxation at source of the interest income since the leasing and rental payments are not subdivided into the different components. However, the interest income contains, in the same way as the interest income in the alternative above, a risk component which covers the risks involved and a basic interest component which is unconnected to such risks. Following the concept above, the first-mentioned component should be taxed in state C. The second-mentioned component, however, can be subject to current taxation in state A.

3.2.6.2. Portfolio Activities

The example can now be extended to an asset management activity where the finance company invests liquid funds into the bond and stock market (portfolio investments).

Figure 6:



Explanations:

(1) Individual A is the sole shareholder of holding company A.
(2) Direct investment of company A in country B through a subsidiary company. The business activities of company B encompass the manufacturing, the marketing and the distribution of goods in country B.
(3) Direct investment of company A in country C. The purpose of subsidiary C is the intra-group cash pooling and financing activities.
(4) Subsidiary C is responsible for portfolio investments (cash management) and the intra-group financing of company B.

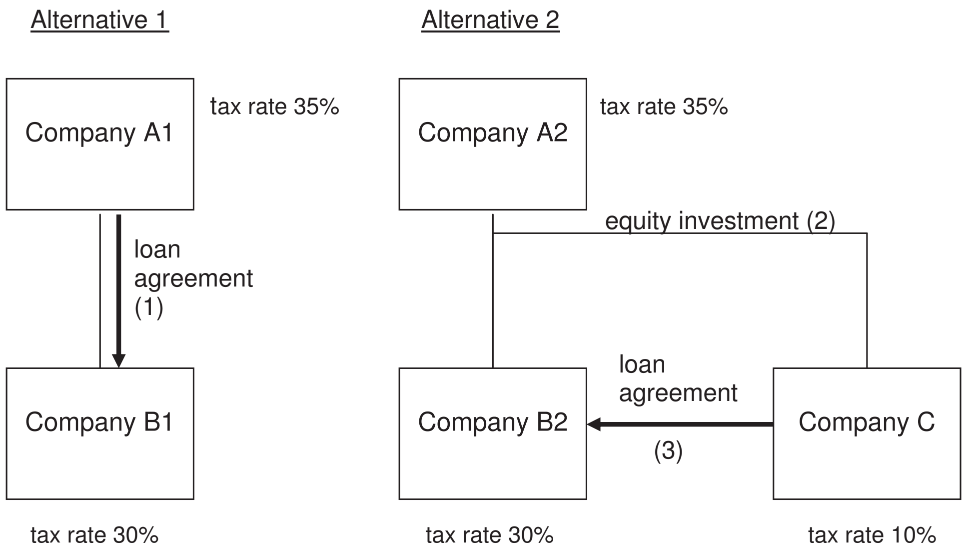
The principles described above for inter-company loan agreements and leasing agreements apply equally to the investment in bonds. In a non-optimal scenario, the interest income derived by company C is to be separated for tax purposes in the same way as outlined above.

In case of dividends and capital gains derived from portfolio investments in shares, the taxation should in general be limited to the source state. In my opinion, this is not only true from a competitiveness point of view but also from an equity perspective. A dividend or capital gains taxation in the state of the intermediate finance company deviates from this general theoretical conclusion. However, this deviation does not justify any immediate residence-based taxation of the dividend income (or income from capital gains) in state A. From my perspective, no argument exists which can be upheld to justify an immediate residence-based taxation in state A just because of the fact that state C taxes the dividends or capital gains, too. In addition, if state C taxes the dividend income with a lower rate than the state of source and allows a tax credit, there is - from the perspective of state A and with respect to equity considerations - no important difference in comparison to a direct holding of the respective shares, i.e. without an interposition of the finance company, apart from the fact that the dividend income (or the proceeds from the disposal of portfolio investments) can be “locked in” in state C. However, the latter can be of some relevance with respect to the subsequent employment of the financial means and the newly created income (see the conclusions above with respect to interest income) but it should be of no relevance for the taxation of the dividends or the proceeds from the disposal of shares itself.

3.2.6.3. The Consequences of Equity and Hybrid Investments for Individual and Corporate Taxpayers

It is obvious from the examinations above that any current taxation of the basic interest component (or the risk-free interest component) in the state of residence of the parent company A does not lead to an optimal result. What is particularly important in this respect is the fact that not the state which provides the benefits receives the tax levied on the interest component but another state, namely the state of residence of the companies A and C. However, in such a non-optimal scenario it is important to concentrate on an equal treatment in the residence-state of the investor. If a residence-based taxation is given as a fact in the relationship between the states A, B and C, the focus must be on an equal treatment with respect to the basic interest component. As already outlined above, the current taxation in state A is theoretically required to be limited to the tax level applied in the source state B. Still, this would not improve the tax position of state B, but it would definitely improve the position of the group of companies with respect to competitiveness (if the taxation in state A were theoretically higher). Moreover, such an approach would lead - within a non-optimal scenario of a residence-based taxation - to an equal treatment of direct loan investments (company A to company B) and indirect loan investments (company C to company B). In both cases, the basic interest component is subject to tax in state A. The latter, however, is only true as long as the tax rate is in both cases - the direct loan investment and the indirect loan investment - limited to the theoretical tax rate of state B. In addition, the limitation in state A to the theoretical tax rate of state B would result in a tax burden imposed on the basic interest component which is as high as the tax burden imposed in state B on the comparable amount of income in case of an equity investment in company B. In other words, the investor in state A would be treated in the same way (with respect to the overall tax burden imposed on the basic interest component but not with respect to the countries imposing the income taxes) no matter whether the financial means are provided through a direct loan investment, an indirect loan investment (via company C) or an equity investment in company B. In my opinion, this is - from an equity perspective - the most preferable result within a non-optimal scenario of a residence-based taxation. In this respect, one has always to keep in mind the alternative to a non-taxation of the basic interest component on a current basis in state A: there will be no taxation based on the benefit theory *and* - in case of an intermediate investment in a low-tax country - the resident investors are treated differently with respect to the basic interest component. Another aspect which has to be clarified is the question whether and in which situation the individual investor should be subject to current taxation. I will come to that aspect below.

Figure 7:



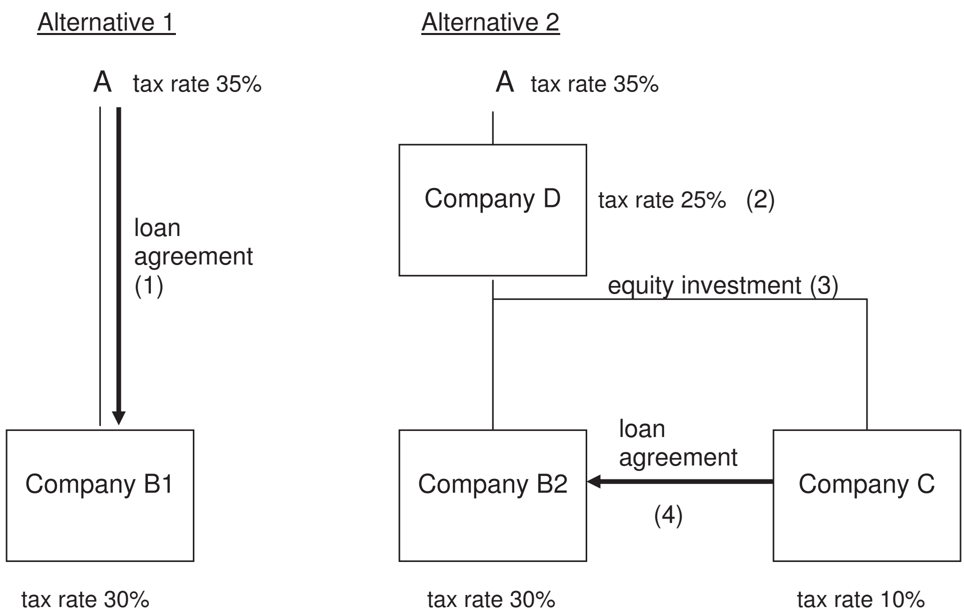
Explanations:

(1) Company A1 grants a loan to company B1.
(2) Direct investment of company A2 in country C.
(3) Company C grants a loan to company B2.

The situation of company A1 and A2 is comparable with respect to the basic interest component. This is not true, however, with respect to the risks involved in the loan agreement. In alternative 1, the risks are taken directly by company A1. For example, if a write-off of the loan amount (and the outstanding interest) is required, the residence-based taxation should lead to a reduction of the tax base in state A. In contrast thereto, the write-off in alternative 2 will directly influence the tax base in state C and not the tax base in state A. The fact that the overall value of the investments is reduced in both alternatives is a different question. The basic interest component is, in principle, free from those risks and should therefore be taxed in an equal manner. In the absence of a source-based taxation in state B, the basic interest component should be allocable to state A in order to provide for an equal treatment of A1 and A2. If a possible withholding tax is left aside for the verification, the basic interest component is taxed in state A - in alternative 1 - at a rate of 35 percent. The tax base in state B is reduced by the interest payments to company A1 (which leads to a reduction in state B of 30 percent). In contrast thereto, and in the absence of a current taxation of income in state A, the interest income in alternative 2 would only be taxed at a rate of 10 percent in state C (which also leads to a reduction in state B of 30 percent). From the perspective of state A, the treatment of the corporations A1 and A2 is different. This different treatment is, in my opinion, not justified with respect to the basic interest component (as already outlined above). Therefore, I consider it necessary to provide for a current taxation of the basic interest income on the level of A2. Only a current taxation of income puts the companies A1 and A2 in a comparable position. However, from a theoretical perspective, the tax rate in state A should be limited in both alternatives to the tax rate applied in state B (30 percent). The situation would not be different if a withholding tax of 10 percent were deducted in state B. In alternative 1, the withholding tax of 10 percent should be credited against the corporate income tax imposed in state A. In alternative 2, the withholding tax should normally be credited against the corporate income tax in state C. Nonetheless, the corporate income tax of state C is taken into account in the state of the parent company A. At the end of the day, this would lead to complete crediting of withholding tax (in state C) and a crediting of the corporate income tax in state A, which leads to a consistent elimination of double taxation. In this example, the allocation of the basic interest component to company A2 leads to an equal treatment of both companies.

The example can now be extended to the level of the ultimate shareholder, i.e. the comparison shall be made between an individual who provides a loan amount to a non-resident company and an individual who structures the investment in the aforementioned manner by interposing a holding company in state D and a finance company in state C.

Figure 8:

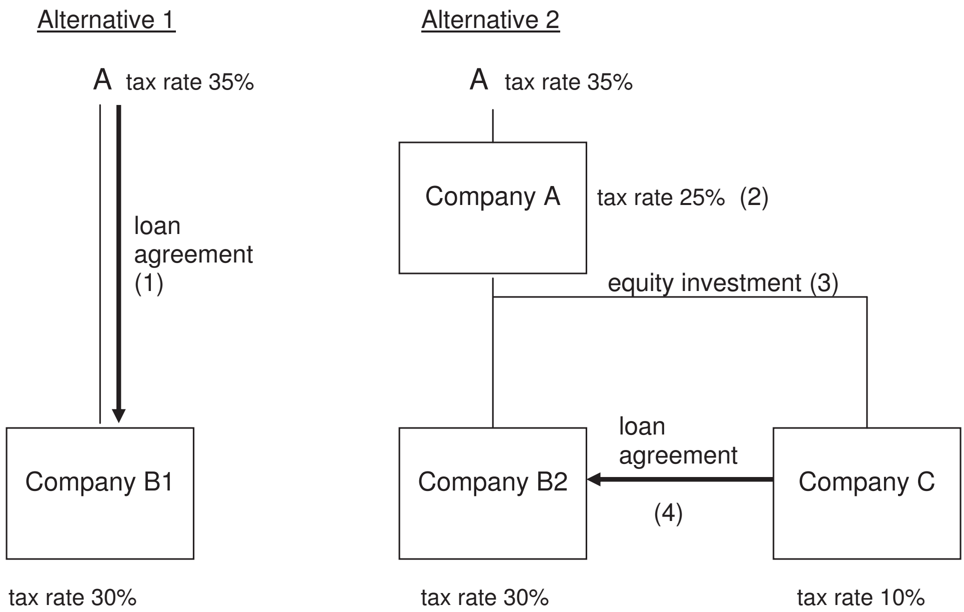


Explanations:

(1) Individual shareholder A grants a loan to company B1. The tax rate in country A is 35 percent.
(2) The corporate tax rate in country D is 25 percent.
(3) Direct investment of company D in country C.
(4) Company C grants a loan to company B2.

Following the principles outlined above, the basic interest rate should be allocated to state D and taxed at the domestic tax rate of 25 percent (a tax credit must be granted - see above). It is not required from an equity perspective to apply the higher corporate income tax rate of state B. However, in order to end up with a taxpayer equity on the level of the individual investor in state A, it is required to allocate the income related to the basic interest component in the same way to the individual shareholder A. Again, the tax rate on the level of the ultimate shareholder should be restricted to the tax rate applicable in state B, i.e. 30 percent, even though the regular tax rate in state A is higher (35 percent). This should consequently apply to the direct interest income and the indirect income via the shareholding in company D. In addition, it should be clear that the corporate income tax deducted in state D (25 percent) is to be credited in state A. Otherwise, a double taxation of income would not be avoided. The decisive question is now whether the allocation of the basic interest component should be limited to cases where the holding company D is rather “inactive” (i.e. limited to the holding of shares without any additional activity) or whether such an allocation is generally required, i.e. also in those cases where the holding company carries on additional business activities. In my opinion, the latter should be true. The reason is that the whole discussion is concentrated on the basic interest component related to the capital invested. Taxpayer equity requires that this component is treated equally. If the intermediate holding company carries on additional activities, those activities have to be remunerated separately. But from a tax perspective, the basic interest component is produced in state B (but not taxed in state B) and is related to the capital provided by the ultimate shareholder. The equal treatment in the state of the individual shareholder requires therefore - in this non-optimal scenario - a comparable taxation. The question arises whether the outcome is different if company D (in state D) is replaced by company A (in state A).

Figure 9:



Explanations:

(1) Individual shareholder A grants a loan to company B1. The tax rate in country A is 35 percent.
(2) The corporate tax rate in country A is 25 percent.
(3) Direct investment of company A in country C.
(4) Company C grants a loan to company B2.

It was outlined earlier that a comparison between a resident corporation (in this case company A) and a resident individual (A) cannot be made without taking into account the existing differences in taxation. However, if the focus is limited to the basic interest component, i.e. the risk-free component which is directly related to the capital investment, it can be argued that the current attribution to company A still leads - in the same way as in case of company D - to a sheltering of the risk-free interest component of capital. The fact that the income is now attributed to a resident company instead of a non-resident company, and the fact that the domestic system of corporate income taxation and individual income taxation may be somehow linked and may be dependent on each other, does not really solve the problem of an unequal treatment. In other words, the basic interest component which can be identified in this hybrid structure requires an equal treatment in the hands of the ultimate domestic investor. Such an equal treatment, however, can only be achieved if the basic interest component - and nothing else - is currently attributed to the individual investor who provides the capital. The attribution of other income components would not support an equal treatment of resident individual taxpayers, because the other income components are either related to functions carried out by another taxpayer or to risks assumed by another taxpayer.

In addition, the question can be raised whether, in general, the outcome should be dependent on the degree of influence of the individual shareholder on the activities of the holding company and the lower tier subsidiaries. In order to answer this question, it may be helpful to briefly review the basic principles which were outlined earlier in this chapter. The decision of taxing the basic interest component is *not* based on the conclusion that there should be, in general, a taxation based on the principle of capital export neutrality for a specific part of income which was produced in another state. The contrary is true: it was my clear proposal to strictly follow the principle of capital import neutrality, no matter whether the investment is a direct investment or a portfolio investment.[39] However, in certain situations - namely in case of hybrid structures - the income is not (or not sufficiently) taxed in the state in which it is produced (state B), but in the state of an intermediate (finance) company (state C). It was concluded that, in the latter situation, the non-current taxation of the basic interest component in state A might foster the interposition of (finance) companies - especially in low-tax states in order to shelter such income from taxation in state A - without supporting the optimal economic result. It was further concluded that, in such a situation, the sheltering of the basic interest component in low-tax states would clearly not be in line with the principle of equity. The basic interest component is directly connected to the *amount of capital investment* and is not influenced by the degree of participation. Thus, if one follows such an argumentation, there is - from an equity perspective - no reason and no necessity to make a differentiation based on the percentage of shareholding.[40]

[39] See with respect to the question of equity and direct / portfolio investments Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, page 393 et seq. Vogel concluded - with respect to income from direct investments - that "*in summary, both considerations of efficiency and equity, as a rule, support exclusive taxation by the source state. In other words, in general preference should be given to a territorial system of taxation. This is true in particular for income from direct investment (…).*" With respect to income from portfolio investments the income should be taxed *"(…) exclusively by the state into which the investment has been made, as far as it can be assumed that creditor countries for the most part are high-taxing, while debtor countries low-taxing*" (see pages 401, 402). See also Kemmeren, who proposes that tax jurisdiction on dividends and capital gains on shares should be assigned - under the principle of origin - to the state in which the profits have been produced. The shareholder's state should refrain from taxing the profits of the company, the capital gains on its shares, and the dividend received. (see Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 543). However, it is apparent that the residence-based taxation is still the predominant system and very few countries tax income on the basis of the pure source principle (see Schindel / Atchabahian, Source and residence: new configuration of their principles, General Report, IFA 2005, page 26 - see also the respective branch reports). The resident individual A (in the example) is very often taxed on the income received from dividends and capital gains. This is usually independent from the percentage of shareholding in the company. However, a differentiation in treatment is sometimes made on the basis of the percentage of shareholding (e.g. the German income tax system (until the end of 2008) provided an exemption from capital gains taxation if the shareholding was less than one percent in the company and the shares were held for more than one year. In contrast thereto, the disposal of shares which conferred a participation of at least one percent was, in general, subject to income taxation). Theoretically, the strict focus on the concept of capital import neutrality and the taxation in the state in which the income is produced makes a differentiation in the state of residence - based on the percentage of shareholding and in this context - obsolete.

[40] The current taxation of the basic interest component is only justified (and necessary) in case of a *non-optimal scenario* where the taxation does not (or not sufficiently) take place in the state in which the income is produced but in another (third) state. It is therefore a limited application of the principle of capital export neutrality (because it only refers to the basic interest component) in certain (limited) situations. The concept cannot be based, as outlined above, on the (general) principles of capital export neutrality - any references would therefore be misleading. However, from an equity perspective, the concept should ensure that the basic interest component is taxed in the hands of the resident investor in the same way as the basic interest component included in a loan amount granted by a resident investor to the legal entity (in a non-optimal scenario). The degree of influence is not decisive. In this respect, a differentiation based on the percentage of participation in the legal entity cannot be based on equity reasons, but may only be based on administrative reasons.

Another aspect which is of importance in the context of taxpayer equity and the current taxation of income is the ability-to-pay principle. From the perspective of the individual taxpayer D it makes a difference whether the income is actually received as an interest payment or whether it is retained on the level of company C in state C. However, it should be kept in mind that the current taxation is solely limited to the basic interest component. Due to the fact that this component is free from additional risks in state C (where it is accumulated), and due to the fact that any current taxation of the basic interest component shall not exceed the actual income derived by company C, a corresponding increase in the net asset value of the shares in company C should be the result. In this respect, the ability-to-pay principle may, in general, not be an obstacle for a current taxation of the basic interest component and the principle of equity. However, the ability-to-pay principle will be examined in more detail later on.

3.3. General Aspects of the OECD Model Tax Convention

3.3.1. The Prevention of International Double Taxation

Due to the fact that states most often do not follow a pure territorial approach but rather a system which combines both, aspects of residence-based taxation and source-based taxation, it is rather common that an overlapping of taxing rights exists. Such an overlapping can consequently lead to a double taxation of income where states exercise the taxing rights embedded in their national tax law without giving a unilateral relief of the taxes levied on the same income in the other state (typically the source state). Such double taxation can - at least partially - be avoided by agreements among states, normally on a bilateral or multilateral basis. In international taxation, two types of double taxation have to be distinguished: the international juridical double taxation and the international economic double taxation. For the purpose of this study and in the context of double tax conventions it is relevant to differentiate between these two types of double taxation.

3.3.1.1. International Juridical Double Taxation

International juridical double taxation is in general defined as "the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods."[41] It is quite obvious that this type of double taxation can have a particularly harmful effect on cross border investments. The removing of these obstacles and therefore the avoidance or the relief from juridical double taxation is therefore considered to be the main purposes of double tax conventions.[42] Among the five elements[43] which are included in the definition there are two elements which are of particular interest in the context of this study. First, the requirement of "the same taxpayer" and second the requirement of "the same subject matter."[44]

[41] Commentary to the OECD-MTC, Introduction, paragraph 1; see also Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 12 and the references in footnote 4.
[42] Commentary to the OECD-MTC, Introduction, paragraphs 2 and 3.
[43] The five elements are: (1.) comparable taxes (2.) which are imposed in two (or more) states (3.) on the same taxpayer (4.) in respect of the same subject matter and (5.) for identical periods.
[44] The element of "identical periods" basically also needs further clarification. The requirement seems to be very restrictive. According to Kemmeren it should not be taken too literally. He even suggests that the element should

The requirement of “the same taxpayer” limits the scope of possible situations considerably. Intra-group double taxation which involves, for example, a parent company and a subsidiary company is therefore out of the scope of the juridical double taxation since there are clearly two different taxpayers. The same should be true where a partnership is considered to be transparent in one state but non-transparent in another. Both treaty states consider a different person to be subject to tax, i.e. the partners of the partnership in one case and the partnership itself in the other.

The requirement of “the same subject matter” is more difficult. Of course, perfect identity does most often not exist. In my opinion, it is rather the general subject matter which must be taken into account in more than one state without being completely identical, e.g. in determining the tax base. This encompasses, *inter alia*, situations in which one contracting state determines the income of a taxpayer in dependence of the income of a different taxpayer in another state. This should even be true where the state first mentioned determines the income of its taxpayer according to domestic rules and consequently ends up with a different result. In such a situation there is a strong economic link between the domestic tax base and the income of the other taxpayer, with the result that the requirement of “the same subject matter” should be fulfilled.

3.3.1.2. International Economic Double Taxation

In contrast to the international juridical double taxation, the international economic double taxation does not require the imposition of taxes on the same taxpayer. It is therefore defined as “the imposition of taxes in two (or more) states on the same economic transaction, item of income or capital during the same period, but in the hands of different taxpayers.”[45] The scope is therefore much wider and encompasses a variety of other double taxation conflicts which are related to different taxpayers.

However, pursuant to the OECD Commentary the scope of the OECD-MTC is limited to juridical double taxation and does not encompass international economic double taxation.[46] It is therefore confusing that the OECD report on partnerships,[47] which explicitly deals with the problems related to qualification conflicts in case of partnerships and therefore a typical form of economic double taxation, was implemented in the OECD Commentary[48] despite the clear focus on juridical double

be waived at all, because of its lack of distinguishing capacity (Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 13).

[45] See Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 14 and the references in footnote 11.

[46] See Commentary to the OECD-MTC, Introduction, paragraph 1, where international double taxation is defined. Paragraph 3 outlines that “(t)his is the main purpose of the OECD Model Tax Convention on Income and on Capital, which provides a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation.” See also the Commentary on Articles 23 A and 23 B concerning the elimination of double taxation which state that “these Articles deal with the so-called juridical double taxation where the same income of capital is taxable in the hands of the same person by more than one State. This case has to be distinguished especially from the so-called economic double taxation, i.e. where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations” (Commentary on Articles 23 A and 23 B, paragraphs 1 and 2).

[47] The Application of the OECD Model Tax Convention on Partnerships, OECD, Paris 1999.

[48] See, e.g. Commentary on Article 1, paragraphs 2-6.7 and Commentary on Articles 23 A and 23 B, paragraphs 32.1 - 32.7.

taxation. In my opinion, the fact that only the problems related to partnerships were covered in the report and subsequently implemented in the Commentary does not give any basis for a general application to economic double taxation. It is even questionable for the explicitly outlined partnership issues.[49]

3.3.2. The Prevention of Tax Avoidance and Tax Evasion

Another purpose of double tax conventions - apart from the prevention of international juridical double taxation - is the prevention of tax avoidance and tax evasion.[50] The prevention of tax avoidance and tax evasion will be discussed in the context of CFC legislation later on and will therefore not be discussed in this chapter.

3.3.3. Allocation of Taxing Rights According to the OECD Model Tax Convention

In the following, the allocation of taxing rights according to the OECD-MTC will be outlined briefly with respect to income, which is of particular relevance in the context of this study. The preceding examinations have shown clearly that the allocation rules are of importance with respect to equity aspects. I will not go into too much detail but instead give a short overview of the principles included in the OECD-MTC.

3.3.3.1. Business Profits

The allocation of taxing rights with respect to business profits is governed by Article 7 (1) of the OECD-MTC which outlines that "(t)he profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."[51] Therefore, the business profits of an enterprise are solely taxable in the country of residence as long as the company does not carry on an activity in another state which fulfils the criteria of a permanent establishment.[52] The transfer of business functions and risks from a company in one state to a company in another state (and therefore a different taxpayer) is typically accompanied by a transfer of taxing rights related to the income connected to those business functions and risks. This, of course, is only true as long as the activities are carried out in the other state and no permanent establishment exists in the first-mentioned state. Here, Article 7 (1) of the OECD-MTC will be applicable to another taxpayer with the effect of a shifting of (future) profits from one state to another.

3.3.3.2. Dividends

The treatment of dividends is stipulated in Article 10 of the OECD-MTC which states that "(d)ividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State."[53] Paragraph

[49] See, *inter alia*, the observations and reservations by the Netherlands, France, and Portugal (Commentary on Article 1, paragraphs 27.1 to 27.3).
[50] Commentary on Article 1, paragraph 7.
[51] Article 7 (1) of the OECD-MTC.
[52] See in this respect Article 5 of the OECD-MTC.
[53] Article 10 (1) of the OECD-MTC.

2 of Article 10 offers a limited taxation at source which shall not exceed 5 percent of the gross amount of the dividends in case the recipient is a company with a shareholding of at least 25 percent, and which shall not exceed 15 percent of the gross amount of the dividends in all other cases.[54]

3.3.3.3. Interest

According to Article 11 (1) of the OECD-MTC the "(i)nterest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State."[55] However, the source state may tax the interest payment pursuant to Article 11 (2) of the OECD-MTC, but the tax shall not exceed 10 percent of the gross amount of interest. Very generally said, the residence-based taxation of interest income pursuant to Article 11 of the OECD-MTC, with a very limited taxation at source, clearly provides the possibility for a taxpayer to shift income from one country to another by switching from equity financing into debt financing and vice versa. This typically leads – in the same way as outlined above with respect to business profits – to a shifting of taxing rights from one country to another. The taxing rights regarding the interest income encompass not only the risk component but also the basic interest component.

3.3.3.4. Royalties

What was stated with respect to interest income is - to a large extent - also true for royalties. However, it is important to note that Article 12 of the OECD-MTC does not provide for a limited taxation at source (in contrast to Article 11 of the OECD-MTC) but grants the taxing rights completely to the residence state of the beneficial owner.[56] As already described earlier, the royalty payments in theory contain different elements such as the compensation for write-offs of the property concerned, a compensation for maintaining the property, a compensation for bearing the risks, and an interest component.[57] Of course, in the context of the OECD-MTC and the Articles 7 and 11 it seems to be consistent to allocate the taxing rights to the residence state of the beneficial owner or to give the source state only a limited right to tax. The same aspects apply to the leasing of tangible property. The leasing of equipment is covered by Article 7 of the OECD-MTC after the amendment of Article 12 (2) of the OECD-MTC in 1992.[58] In the latter case, the total income - encompassing all four elements outlined above - is allocable to the state in which the leasing company is resident.[59] The result of taxing the complete income derived from the licensing and leasing out of property in the residence state of the beneficial owner is - again - not in line with the principles stipulated earlier.

[54] Article 10 (2) of the OECD-MTC.
[55] Article 11 (1) of the OECD-MTC.
[56] Article 12 (1) of the OECD-MTC. With the exception in case of a permanent establishment (Article 12 (3) of the OECD-MTC).
[57] Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 82. See also Vogel who subdivides the payments into three parts since he considers the compensation for maintaining the property and for bearing the risk to be one single part (see Vogel, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, page 310 et seq. (318).
[58] Vogel / Lehner, Doppelbesteuerungsabkommen, Kommentar, 4. Auflage (2003), Art. 7, Rz. 9.
[59] In the absence of a permanent establishment.

3.3.3.5. Capital Gains

Article 13 of the OECD-MTC, which deals with capital gains, stipulates a separation according to the property concerned. The alienation of immovable property may be taxed in the state where the immovable property is situated.[60] The same is true for the disposal of shares when the total value is mainly based on immovable property situated in the other contracting state.[61] The disposal of movable property forming part of the business property of a permanent establishment may be taxed in the state of the permanent establishment,[62] and the disposal of ships and similar property is connected to the effective management of the enterprise.[63] However, what is more important is Article 13 (5) of the OECD-MTC: "Gains from the alienation of any property, other than referred to in paragraphs 1, 2, 3 and 4, shall be taxable only in the Contracting State of which the alienator is a resident."[64] This covers, *inter alia*, all tangible and intangible assets of a resident company without a permanent establishment in the other contracting state, e.g. the tangible and intangible assets which are the basis for the leasing and royalty income.

3.3.3.6. Other Income

Pursuant to Article 21 of the OECD-MTC, the items of income of a resident of a contracting state not dealt with in the other articles of the Model Tax Convention shall be taxable only in the state of residence - with the exception of income effectively connected to a permanent establishment in the other contracting state.[65]

3.3.4. The OECD Model Tax Convention and the Methods of Avoiding International Double Taxation

The OECD-MTC in general provides two leading methods of avoiding international double taxation, namely the exemption method[66] and the credit method.[67] Under the exemption method, the state of residence does not tax the income which according to the convention may be taxed in the other state.[68] The principle of exemption may be applied by two main methods: the "full exemption" according to which the state of residence does not take the income into consideration at all and the "exemption with progression" according to which the foreign income is taken into consideration for the determination of the applicable domestic tax rate.[69] In contrast, under the credit method the state of residence calculates its tax on the taxpayer's total income including the foreign income which, according to the convention, may be taxed in the other state. The state of residence allows a deduction from its own tax for the tax paid in the other state.[70] In general, this can be structured as a "full credit" or an "ordinary credit."[71] The latter is restricted to the tax levied on the foreign income in

[60] Article 13 (1) of the OECD-MTC.
[61] Article 13 (4) of the OECD-MTC.
[62] Article 13 (2) of the OECD-MTC.
[63] Article 13 (3) of the OECD-MTC.
[64] Article 13 (5) of the OECD-MTC.
[65] Article 21 (1), (2) of the OECD-MTC.
[66] Article 23 A of the OECD-MTC.
[67] Article 23 B of the OECD-MTC.
[68] Commentary on Articles 23 A and 23 B, paragraph 13.
[69] Commentary on Articles 23 A and 23 B, paragraph 14.
[70] Commentary on Articles 23 A and 23 B, paragraph 15.
[71] Commentary on Articles 23 A and 23 B, paragraph 16.

the state of residence. There is basically no preference for one of the two methods of avoiding international double taxation included in the MTC (exemption method and credit method) and it is possible to insert both methods in a respective double tax convention.[72]

The taxation of interest income requires the crediting of a withholding tax when the taxing rights are split between the source state (withholding tax) and the residence state.[73] The same is true for royalty income if a withholding tax is stipulated in the respective double tax convention (Article 12 of the OECD-MTC does not provide for a limited taxation at source). Business profits are only taxable in the residence state as long as no permanent establishment exists in the other state. In the latter case, both methods are applied to avoid double taxation. The treatment of dividends depends upon whether the shareholder is an individual or a corporate shareholder. Typically, the credit method is applied to individual shareholders whereas both methods are applied for corporate shareholders.

3.3.5. The OECD Model Tax Convention and Hybrid Investments

The legal structure of an international group of companies is often influenced by tax aspects. It is obvious to me that the OECD-MTC and its concept of allocating taxing rights clearly supports the creation of hybrid structures. I would like to come back to the example of a parent company in state A with an “active” manufacturing and marketing subsidiary in state B and a finance (or leasing) subsidiary in state C. State C shall be considered to be a low-tax state in this example.

From the perspective of the parent company A, the investment in state B is generally taxed in the latter state according to Article 7 of the OECD-MTC as long as there is no permanent establishment in state A (or any other state). Even though the business profits accumulated in state B will generally be taxable as soon as they are remitted to state A in the form of a dividend payment, it has to be considered that the distribution is very often exempt from taxation according to the domestic legislation of state A, or is subject to tax but allows the crediting of the foreign tax paid in state B by the foreign subsidiary. However, part of the business profits of company B can be easily transferred to state C. The financing of the business activities of company B as well as all other services rendered will be taxable in state C pursuant to Article 7, Article 11 and Article 12 of the OECD-MTC - with the exception of a limited withholding tax in state B and in case of a permanent establishment. The residence-based taxation certainly supports the outsourcing to a separate legal entity (and therefore a separate taxpayer) in the low-tax country C. It provides the possibility of income taxation in state C at a lower tax rate and the sheltering from the higher domestic taxation in state A. The latter, i.e. the deferral of income taxation in state A, is only true in the absence of a CFC legislation in state A (or similar anti-deferral measures). One could argue that it does not really matter for the taxation in state A whether the equity investment is only made in state B or whether the same amount of equity is split-up over the two states B and C - with additional activities of company C towards company B. However, it was outlined above that there are convincing economic and equality arguments against this position, at least with respect to the basic interest component included in the income.

[72] Commentary on Articles 23 A and 23 B, paragraphs 28-31.
[73] See in this respect also Article 23 A paragraph 2.

The arguments would be even stronger if the services of company C were not only directed towards company B but also towards the parent company A, i.e. in cases where the parent company - for example - makes an equity investment in company C and receives, subsequently, a loan from the subsidiary company in order to finance its own activities.[74] Such a structure would directly influence the domestic tax base in country A. Also in this situation, the interest paid to company C would be taxable in state C and would only be subject to a limited withholding tax in state A.

Overall, the provisions of the OECD-MTC, especially with respect to business profits, interest income and royalty income, give enough leeway for a group structure which can lead - from the perspective of the state of the parent company - to an additional capital outflow towards foreign companies in order to supply inter-company services. This has the consequence of a limitation of taxing rights and can even have the effect of a permanent erosion of the domestic tax base. If one takes into account that according to a report issued by the United Nations Conference on Trade and Development (UNCTAD) about 80 percent of royalty payments worldwide are made between related parties, it seems to be rather obvious that hybrid structures will play a more and more important role in international taxation.[75]

3.4. Conclusions

1.) Equity aspects require a source-based taxation rather than a residence-based taxation of direct investments. The same should be true with respect to portfolio investments.

2.) The OECD-MTC generally provides for a residence-based taxation of dividend income, interest income and royalty income. In case of dividend and interest income the OECD-MTC provides for a limited taxation at source. Business profits are taxable in the residence state as long as no permanent establishment exists in the other contracting state.

3.) The allocation of taxing rights based on the OECD-MTC supports, in my view, the creation of hybrid structures in which service companies of any type are implemented in an international group structure. Those service companies are often incorporated in low-tax countries, i.e. the international group can take advantage of the lower level of taxation which is generally possible because of the residence-based taxation in the low-tax country and the limited source-based taxation in the high-tax country. Those service companies should in general be taxed in the state in which the business functions are exercised. This is typically the residence state of the service company as long as no permanent establishment exists in the other contracting state. The functions have to be measured on an arm's length basis. This should be in line with equity considerations.

4.) Interest income should be taxable in the source state. In this respect, the source state has to be seen as the state in which the income-producing activity is carried on and in which the income which is the basis for the interest payment is actually "created." If this is the case, the income related to an equity investment and the income related to a loan investment are treated in a comparable manner for tax

[74] This will be discussed in more detail later on.
[75] The report was issued in the year 2000. See Schindel / Atchabahian, Source and residence: new configuration of their principles, General Report, IFA 2005, page 54.

purposes. This would also lead to an equal treatment of resident and non-resident investors which would both be subject to tax in the state of source. Both types of investors would be taxed according to the benefits received and both would be in a comparable position to compensate for the risks inherent in the business activities carried on in the source state. However, since the OECD-MTC provides for a residence-based taxation of interest income (and a limited taxation at source), this can be considered - in my opinion - to be a *non-optimal scenario* from an equity point of view. In such a non-optimal scenario, the interest income has to be split-up into a risk component and a basic interest component (risk-free component). The income which is related to the risk component should be taxable in the same way as the exercising of business functions, i.e. in the state where the risk is taken directly, which is typically the state in which the service company carries on its activities (e.g. in case of a hybrid investment). The basic interest component, however, should be allocable to the state where the invested capital comes from. The reason is that in the absence of an optimal scenario of a source-based taxation, the comparison between resident investors becomes decisive. In this respect, equity aspects require a comparison either between resident individuals or a comparison between resident corporations. A direct comparison between resident individuals and resident corporations can only lead to an appropriate result if the differences in tax treatment between individuals and corporations are taken into account.

5.) In a non-optimal scenario, the equal treatment of taxpayers makes it necessary to currently allocate the basic interest component to the resident taxpayer. In general, this should be the ultimate individual shareholder who provides the capital for the investment. Any other approach supports the sheltering of the risk-free interest component of capital. This might even be true in case of an interposition of a *resident* intermediate (holding) company. In my opinion, the absence of a current taxation of income in case of an identifiable basic interest component - within the aforementioned described hybrid structures - would result in an unequal treatment of resident individual investors. However, it is equally clear that the current taxation of income should not encompass any other income components apart from the basic interest component. The reason is that the other income components are either related to functions carried out or to risks assumed by another taxpayer. This conclusion is not dependent upon the fact whether, for example, an intermediate (holding) company actively carries out business activities or whether the individual shareholder has a decisive influence on the activities of the holding company and any other subsidiary companies.

6.) The taxation of the basic interest component should follow the principles outlined in the previous chapter. Based on these principles, the basic interest component should be taxed on a “rolling” basis, i.e. the increase or decrease over the period of investment is to be taken into account. This ensures the taxation of the risk-free (minimum) income in the state of the shareholder. However, the taxation of the basic interest component must be limited (as a maximum) to the positive income derived by the intermediate service company. Any other approach might lead to the taxation of income which is not existent.

7.) Royalty and leasing income has to be separated into four different parts: a compensation for write-offs of the property concerned, a compensation for maintaining the property, a compensation for bearing the risks, and an interest component. Consequently, the income related to the first three components should be taxed in the country where the service company carries on the income-producing activity. The interest component included in the payments should be treated in the same way as the interest income outlined above. Theoretically, a separation of the interest component from the other components could be made by stipulating a certain percentage of the payments which should reflect the interest component and which should be taxed in the source state. The percentage could be stipulated by protocol or mutual agreement or, alternatively, a standard could be included in the double tax convention. However, the OECD-MTC provides for a residence-based taxation of the total amount of income without separating the income into the different elements.

8.) In case of dividends and capital gains derived from portfolio investments in shares, the taxation should be limited to the source state. Contrary to the interest component included in interest payments, royalty payments or leasing payments, the profit underlying the dividends and capital gains is already taxed in the source state. Thus, a subsequent taxation of the dividends or capital gains is not required by equity aspects.

9.) Thus, the concept of a current taxation of the basic interest component in the hands of the resident taxpayer is supported by economic and equity principles. Both, economic and equity aspects, require - in principle - that the foreign income should be taxed in the state in which the income-producing activity is carried on. However, if this optimal result cannot be achieved, other aspects have to be taken into consideration. Therefore, if a residence-based taxation leads to a shifting of taxing rights, with the effect that the income is not taxed in the state in which the income is produced but in the state in which the capital is legally concentrated, it is necessary to separate the basic interest component - which is neither related to the exercising of certain functions nor to the taking over of risks in the state of the intermediate company - and to allocate this interest component to the state the capital comes from. The taxation itself should theoretically be limited to the tax burden applicable in the state of source. The latter is true for both, the current taxation of the basic interest component in case of an indirect financing structure (via an intermediate company) and the taxation in case of a direct loan investment. The reason for such a limitation is the fact that this is, in my opinion, the only possibility to support the competitiveness of the group within a non-optimal scenario of a residence-based taxation. Without such a limitation, the group might be subject to a higher taxation than in case of a strict source-based taxation (at least with respect to the basic interest income) and would therefore face a competitive disadvantage on a group level. In other words, if the optimal result cannot be achieved, the overall tax burden imposed on the basic interest component should not exceed the income tax rate which would be applied in case of a taxation at source. In this case, the resident investor would be treated in the same way (with respect to the overall tax burden imposed on the basic interest component but not with respect to the countries imposing the income taxes) no matter whether the financial means are provided through (i) a direct loan investment, (ii) an indirect loan investment (or a similar investment which contains a separable financing element) - through the interposition of an intermediate company - or (iii) an equity investment in the company which produces the income (with respect to the comparable amount of income). In my opinion, this is - from an equity perspective - the most preferable result within a non-optimal scenario of a residence-based taxation. Such an approach is therefore not only supported by the economic principles outlined in the previous chapter, but is also supported by equity considerations. In essence, it leads to a partial and strictly limited application of the principle of capital export neutrality.

4. European Union Law

4.1. Introduction

It is obvious that the EU law is of utmost importance for the application of the CFC regimes of the Member States. It is especially the case law of the ECJ which permanently reminds the Member States that, although direct taxation falls within the competence of the Member States, the latter must exercise that competence consistently with EU law. In the following, the basic freedoms which may be of importance for this study will be examined based on the case law of the ECJ. This will not only encompass the scope of the basic freedoms but also the justifications under the rule of reason for restrictions on the basic freedoms. With respect to the scope of the basic freedoms I will not go into detail regarding all cases which might somehow be (indirectly) relevant for CFC taxation, but I will concentrate on some basic decisions which are, in my opinion, particularly important in this context. In contrast thereto, the justifications are discussed separately - structured according to the type of justification and not on a case-by-case basis. Moreover, it is also the secondary EU law which may affect the application of such regimes. The Parent-Subsidiary Directive will therefore be examined in this context as well. This should provide the general basis for a verification of the concept of CFC taxation in the light of the basic freedoms of the Treaty on the Functioning of the European Union (TFEU) and the secondary EU law (in chapter 8), and should further provide the basis for an alternative concept (in chapter 9).

4.2. Primary European Union Law - The Basic Freedoms

Primary EU law requires to examine first of all the scope of the basic freedoms which may be of particular importance in the context of this study. The relevant basic freedoms are the freedom of establishment, the freedom to provide services, and the free movement of capital and payments. After determining the scope of the latter basic freedoms, it is also necessary to identify whether precedence has to be given to one of the basic freedoms, e.g. in case of a simultaneous application of basic freedoms, and to examine the application of the relevant basic freedoms in relation to states outside of the EU. Last but not least, the question of the abuse of the basic freedoms is to be verified.

4.2.1. The Freedom of Establishment

Article 49 of the TFEU states that "(...) *restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State*."[1] In the second paragraph of Article 49 it is outlined that *"(f)reedom of establishment shall include the right to take up and pursue activities and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital*."[2] The freedom of establishment is conferred upon individuals ("natural persons") who are nationals of a

[1] Article 49 paragraph 1 of the TFEU.
[2] Article 49 (2) of the TFEU.

Member State and companies or firms[3] formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union.[4] The freedom of establishment therefore not only encompasses the right to set up new undertakings in another Member State (primary establishment) but also the right to set up agencies, branches or subsidiaries of existing undertakings (secondary establishment).[5] Thus, it is quite obvious that Article 49 of the TFEU could be of particular relevance for the investment in controlled foreign companies. However, in order to determine the scope of the freedom of establishment it is of utmost importance to verify and evaluate the existing case law of the ECJ.

4.2.1.1. Case Law of the European Court of Justice

4.2.1.1.1. The *Daily Mail* Case

In the *Daily Mail* case [6] the ECJ had to decide on the question of a primary establishment in another Member State. By transferring the central management and control from the UK to the Netherlands, *Daily Mail* wanted to avoid the capital gains taxation of shares held by the company. In its decision, the Court pointed out that the freedom of establishment also prohibits *"(…) the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation."*[7] The latter, of course, is a very important conclusion in the context of this study. Before *Daily Mail*, a number of commentators took the position that the freedom of establishment solely protects host state discrimination.[8] Pursuant to Knobbe-Keuk, the ECJ does not attach much importance to a historical interpretation of the EC Treaty which would justify an application of the freedom of establishment principles only to the host state legislation.[9] In the following, the Court made a distinction between natural persons and companies.[10] For companies, the freedom of establishment is generally exercised by the setting-up of agencies, branches or subsidiaries. *"Indeed, that is the form of establishment in which the applicant engaged in this case by opening an investment management office in the Netherlands. A company may also exercise its right of establishment by taking part in the incorporation of a company in another Member State (...)."* [11] The Court pointed out that according to the present state of EC law (now EU law), the

---

[3] Article 54 (2) of the TFEU states that "companies" or "firms" means companies or firms constituted under civil or commercial law, including co-operative societies, and other legal persons governed by public or private law, save for those which are non-profit-making.
[4] Article 54 (1) of the TFEU.
[5] Terra / Wattel, European Tax Law, 1997, page 25.
[6] Case 81/87 *(The Queen v. H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust PLC),* September 27, 1988, ECR 1988 page 5483. See with respect to this case also Thiel, Daily Mail Case: Tax Planning and the European Right of Establishment: A Setback, European Taxation 1988, page 357 et seq.
[7] Case 81/87 (*Daily Mail*), paragraph 16. This was basically confirmed by the ECJ in later cases (e.g. case C-264/96 (*ICI*), paragraph 21; case C-200/98 (*X and Y*), paragraph 26; case C-251/98 (*Baars*), paragraph 28).
[8] See in this respect Troberg in Groeben / Thiesing / Ehlermann, Kommentar zum EU-/EG-Vertrag, 5th Edition, 1997. See with respect to "home-state restrictions" Bergström / Bruzelius, Home-State Restrictions on the Freedom of Establishment in a Swedish Income Tax Law Perspective, Intertax 2001, page 233 et seq.
[9] Knobbe-Keuk, Die Niederlassungsfreiheit: Diskriminierungs- oder Beschränkungsverbot?, Der Betrieb 1990, page 2574; Daniels, The Freedom of Establishment: Some Comments on the *ICI* Decision, EC Tax Review 1999, page 39 et seq. (40).
[10] Case 81/87 (*Daily Mail*), paragraph 16.
[11] Case 81/87 (*Daily Mail*), paragraph 17.

freedom of establishment confers no right to transfer the central management and control to another Member State.[12] What is now of some relevance - especially for the purpose of this study - is the fact that the Court clearly stipulated that the freedom of establishment prohibits the Member State of origin from hindering the secondary establishment in another Member State. It is also very interesting, however, that the Court did not explicitly limit the right of establishment to a certain kind of activity. In the case itself, the *Daily Mail and General Trust PLC* was an "investment holding company."[13] The Court pointed out that the company can exercise that right of establishment by opening an "*investment management office*" in the Netherlands. Therefore, the following basic conclusions can be drawn which are of importance in the context of this study:

1.) an investment holding company can exercise its right of establishment by itself; and

2.) the right can be exercised by establishing an investment management office or an investment management subsidiary in another Member State;

3.) the right of establishment prohibits the Member State of origin from hindering the establishment of one of its nationals or of a company incorporated under its legislation in another Member State.[14]

Of course, the case law related to the question of primary establishment has been developed further and was verified by the ECJ in a number of additional cases.[15] Here, I will not go into detail of this particular question since the aforementioned conclusions related to *secondary* establishment are still valid. The questions related to *primary* establishment are of no comparable importance for this study and shall therefore not be addressed.

4.2.1.1.2. The *Factortame* Case and the *Jaderow* Case

The *Factortame* case[16] and the *Jaderow* case[17] both deal with questions relating to the compatibility of national legislation laying down the conditions for the registrations of fishing vessels with EC law (now EU law). One of the interesting aspects of the *Factortame* case is the fact that the Commission argued that the registration of a vessel constituted *in itself* an act of establishment and that therefore the rules on the freedom of establishment were applicable.[18] In that regard, the Court stated that "*the concept of establishment within the meaning of Article 52 et seq. (now Article 43 et seq.) of the Treaty involves the actual pursuit of an economic activity through a fixed*

[12] Case 81/87 (*Daily Mail*), paragraph 25.
[13] See case 81/87 (*Daily Mail*), paragraph 6.
[14] See in this respect also Daniels, The Freedom of Establishment: Some Comments on the *ICI* Decision, EC Tax Review 1999, page 39 et seq. (40); Terra / Wattel, European Tax Law, 1997, page 109.
[15] See case C-212/97 (*Centros*), case C-208/00 (*Überseering*), case C-167/01 (*Inspire Art*), case C-210/06 (*Cartesio*). See with respect to the question of primary establishment and the aforementioned case law Müller, *Cartesio* (Case C-210/06), Tax Planning International European Tax Service, March 06, 2009. See also Haase, Genzüberschreitende Sitzverlegung von Kapitalgesellschaften vor und nach dem Urteil des EuGH vom 5.11.2002 (Rs. „Überseering"), Internationale Wirtschafts-Briefe 2003, Fach 11, Gruppe 2, page 529 et seq.
[16] Case C-221/89 *(The Queen v Secretary of State for Transport, ex parte Factortame Ltd. and others*), July 25, 1991, ECR 1991, page I-03905.
[17] Case C-216/87 *(The Queen v Ministry of Agriculture, Fisheries and Food, ex parte Jaderow Ltd.),* December 14, 1989, ECR 1989, page 04509.
[18] Case C-221/89 (*Factortame II*), paragraph 19.

establishment in another Member State for an indefinite period" [19] and "*consequently, the registration of a vessel does not necessarily involve establishment within the meaning of the Treaty, in particular where the vessel is not used to pursue an economic activity or where the application for registration is made by or on behalf of a person who is not established, and has no intention of becoming established, in the State concerned. However, where the vessel constitutes an instrument for pursuing an economic activity which involves a fixed establishment in the Member State concerned, the registration of that vessel cannot be dissociated from the exercise of the freedom of establishment."* [20] This is exactly the point: the vessel may constitute an *instrument* for the exercising of an economic activity, but in order to exercise the right of establishment the *instrument must be used* in order to pursue an economic activity.

Another interesting aspect was the requirement that the vessel must be managed and its operations directed and controlled from within the Member State. In this regard, the Court pointed out that this "*essentially coincides with the actual concept of establishment (…), which implies a fixed establishment. It follows that those articles, which enshrine the very concept of freedom of establishment, cannot be interpreted as precluding such a requirement. Such a requirement, however, would not be compatible with those provisions if it had to be interpreted as precluding registration in the event that a secondary establishment or the centre for directing the operations of the vessel in the Member State in which the vessel was to be registered acted on instructions from a decision-taking centre located in the Member State of the principal establishment."* [21] Therefore, the Court concluded that it is not contrary to EC law (now EU law) to stipulate conditions which require that the vessel must be managed and its operations directed and controlled from within the Member State.[22] This conclusion is the logical consequence of the required fixed establishment. This, however, does not have to be understood in a way that the economic activity must be partially directed *towards* the host Member State. Nothing is included in the decision which indicates such a conclusion. The statement of the Court can be especially relevant in the context of this study. The *instrument "vessel"* can be easily replaced by other tangible and intangible assets, which can be - for example - certain rights, financial means and loan receivables. The assets can only be an instrument which has to be utilised in order to *pursue an economic activity*. The instrument itself is not sufficient. Another important fact is that the respective economic activity must be pursued through *a fixed establishment* in the other Member State for an *indefinite period* and that the instructions from a decision-taking centre (in most cases head office or parent company) located in the Member State of the principal establishment will not negatively affect the right of establishment.

The *Jaderow* case, which was decided earlier, shows that the possibilities of a Member State stipulating conditions to provide evidence of an economic link with the respective Member State are limited.[23] The related cases *Factortame* and *Jaderow* [24] are - in combination - important for the definition of the scope of the freedom of establishment. It is clear from the cases that the freedom of establishment requires

[19] Case C-221/89 *(Factortame II),* paragraph 20.
[20] Case C-221/89 *(Factortame II*), paragraphs 21 and 22.
[21] Case C-221/89 *(Factortame II*), paragraphs 34 and 35.
[22] Case C-221/89 *(Factortame II*), paragraph 36.
[23] Case C-216/87 *(Jaderow*), paragraphs 43, 44.
[24] Related in the sense that they are dealing with the same subject matter.

the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period of time. However, the Member State which requires evidence of an economic link may not stipulate exclusive conditions but has to admit any kind of evidence to proof such an economic link.

4.2.1.1.3. The *Gebhard* Case

The *Gebhard* case[25] deals with the situation of a German lawyer who moved to Italy. The local Italian Bar Council prohibited Mr. Gebhard from using the title "avvocato" and imposed the sanction of suspension from pursuing his professional activity for a certain period of time. The conclusions of the Court with respect to the concept of establishment are very interesting in this respect. The Court held that *"(t)he concept of establishment within the meaning of the Treaty is (…) a very broad one, allowing a Community national to participate, on a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom, so contributing to economic and social inter-penetration within the Community in the sphere of activities as self-employed persons*." [26] The Court already outlined in the *Reyners* case that the directives provided for by the Treaty fulfil the function to introduce into the law of the Member States a set of provisions intended to facilitate the effective exercise of the freedom of establishment for the purpose of assisting economic and social inter-penetration within the EC (now EU).[27] Economic and social inter-penetration can be regarded as one of the aims of the Treaty.[28] The wording "*concept of establishment (...) is therefore a very broad one*" which was used in the *Gebhard* case has to be seen, in my opinion, in contrast to the freedom to provide services, which only leads to a temporary link to the other Member State. Even though this does not necessarily mean that there is no local binding, e.g. in the form of an office,[29] it has to be distinguished from a national who pursues an activity on a stable and continuous basis in another Member State.[30] Applying the statement of the Court in the *Gebhard* case and the *Reyners* case to a service company with limited activities - but on a continuous basis - in the state of secondary establishment which provides services towards recipients in other (third) states, the outcome should be that such a company is nonetheless within the scope of the freedom of establishment and is not outside of the scope just because of the fact that the company only supplies services to recipients in other states.[31] This, of course, has to be distinguished from abusive structures which will be discussed separately. Even though the economic and social interrelation with the host Member State could be very limited in such cases, it cannot be overlooked that the possibility of close interrelation with the host Member State is basically a right ("*to profit therefrom*") and not an obligation. It is therefore clear to me that there is no necessity to supply *any* services to recipients within the Member State of the secondary establishment.

[25] Case C-55/94 (*Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*), November 30, 1995, ECR 1995 page I-04165.
[26] Case C-55/94 (*Gebhard*), paragraph 25.
[27] Case 2/74 (*Jean Reyners v Belgian State*), June 21, 1974, ECR 1974 page 631, paragraph 21.
[28] Article 2 (ex Article 2) of the EC Treaty.
[29] Case C-55/94 (*Gebhard*), paragraph 27.
[30] Case C-55/94 (*Gebhard*), paragraph 28.
[31] The wording in the *Gebhard* case is misleading in this respect: "*However, that situation is to be distinguished from that of Mr. Gebhard who, as a national of a Member State, pursues a professional activity on a stable and continuous basis in another Member State where he holds himself out from an established professional base to, amongst others, nationals of that State."* (See case C-55/94 (*Gebhard*), paragraph 28).

4.2.1.1.4. The *Imperial Chemical Industries (ICI)* Case

The *Imperial Chemical Industries (ICI)* case[32] entails questions which can be important with respect to the definition of the scope of the freedom of establishment. The facts are the following: two companies resident in the UK formed a consortium through which they beneficially owned 49 percent (*ICI*) and 51 percent (*Wellcome Foundation Ltd.*), respectively, of a holding company in the UK*)*. The sole business of the holding company was to hold shares in resident and non-resident trading companies. One of the resident trading companies incurred losses on its UK trading activities. *ICI* sought to set 49 percent of those losses against its chargeable profits for the corresponding periods by way of tax relief.[33] The Inland Revenue refused the application because of the fact that the majority of subsidiaries were non-resident companies.[34] One of the interesting points in the *ICI* case is that the Court explicitly clarified that the freedom of establishment can be exercised through a holding company. The Court stated that *"(…) Article 52 (know Article 43) of the Treaty precludes legislation of a Member State which, in the case of companies established in that State belonging to a consortium through which they control a holding company, by means of which they exercise their right to freedom of establishment in order to set up subsidiaries in other Member States, makes a particular form of tax relief subject to the requirement that the holding company's business consist wholly or mainly in the holding of shares in subsidiaries that are established in the Member States concerned."* [35] A holding company can therefore be a "vehicle" for companies (or individuals) to rely - indirectly - on the right of establishment. This does not mean that the holding company itself cannot exercise the freedom of establishment. But in the underlying case it was the shareholder of the holding company who claimed a 49 percent tax relief and not the holding company itself.[36] In a different situation, e.g. in a hypothetical case of a cross-border fiscal unity (or tax consolidation) in which - for example - the holding company would be the parent in the fiscal unity, the right of establishment would be directly exercised by the holding company. The Court is in my opinion very clear in that respect. The wording "*by means of which they exercise their right of establishment*" does not necessarily imply that a holding company itself is entitled to claim the right of establishment (in this case the right of secondary establishment) since it was just a "vehicle" in the underlying case. However, the entitlement of a holding company - under certain circumstances - was already confirmed in the *Daily Mail* case.[37] From *ICI* we can learn that the right of secondary establishment can be indirectly exercised by means of a holding company, although this does not necessarily imply that the holding company itself is entitled to exercise

[32] Case C-264/96 (*Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer*), July 16, 1998, ECR 1998, page I-4695. See with respect to this case also Corben, Commentary on the ICI v Colmer Case, The EC Tax Journal 1998, page 29 et seq.; Hughes, Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes), Bulletin for International Fiscal Documentation 1999, page 13 et seq.; Cussons, The Sleeping Dragons Stir, The Tax Journal 1999, page 11 et seq.; Cussons, The Wider European Implications of *the ICI v. Colmer* Judgement, Tax Planning International Review 1999, pages 10, 11; Rupal / Todd, EU Court Opens Group Opportunities, International Tax Review 1999, page 46 et seq.; Daniels, The Freedom of Establishment: Some Comments on the *ICI* Decision, EC Tax Review 1999, page 39 et seq.
[33] So-called "consortium relief", Section 258 – 264 ICTA 1970 (respectively 1988).
[34] Case C-264/96 (*ICI*), paragraph 7; Section 258 ICTA 1970 (respectively 1988).
[35] Case C-264/96 *(ICI*), paragraph 30.
[36] See in this respect also Daniels, The Freedom of Establishment: Some Comments on the *ICI* Decision, EC Tax Review 1999, page 39 et seq. (40).
[37] See case 81/87 (*Daily Mail*). Of course, this is only true for companies formed in accordance with the law of the Member States and having their registered office, central administration or principal place of business within the EU (Article 54 of the TFEU).

the right of establishment. For the entitlement of the right of establishment it is required that the holding company pursues an economic activity through a fixed establishment in another Member State for an indefinite period.[38] If this is the case, there is, of course, no reason to treat the activity of a holding company different from any other kind of economic activity. This, however, will be verified below.

4.2.1.1.5. The *Baars* Case

The *Baars* case[39] deals with a Dutch resident who owned all of the shares in an Irish company. He claimed a wealth tax allowance which could be applied for substantial shareholdings in a company or partnership established in the Netherlands.[40] Substantial shareholding in the sense of the respective legislation was a holding for the last five years of at least one third of the shares in a company and more than seven percent of paid-up nominal capital.[41] The requirements were fulfilled, with the exception of the shareholding in a company established in the Netherlands. The Court pointed out that the domestic requirements did not necessarily imply "*control or management*" of the company, "*which are factors connected with the exercise of the right of establishment.*"[42] With such a statement, the Court made it clear that *control* or *management* of the company are prerequisites for the exercise of the right of establishment. The conclusion that the respective provision does not necessarily affect the freedom of establishment is therefore consistent. In the underlying case, however, Mr. Baars was the sole shareholder of the Irish company. *"A 100% holding in the capital of a company having its seat in another Member State undoubtedly brings such a taxpayer within the scope of application of the Treaty provisions of the right of establishment."*[43] In the following, the Court stated that *"(…) a national of a Member State who has a holding in the capital of a company established in another Member State which gives him definite influence over the company's decisions and allows him to determine its activities is exercising his right of establishment"* [44] and a *"definite influence over the company's decisions"* and the possibility *"to determine its activities"* is *"self-evidently always the case wherever there is a 100% holding."* [45]

After the *Baars* decision it is clear that a 100 percent shareholding brings the taxpayer within the scope of the right of establishment, and that a minority shareholding without influence, control or management of the company is outside of the scope of the right of establishment. But what about the situations in between? For example a 51 percent shareholding, a 50 percent shareholding, a minority shareholding with additional voting rights and management functions etc.? What about the *ICI* case? ICI had a 49 percent shareholding in a holding which, in turn, was the shareholder of companies in other Member States. The Court had to verify

---

[38] See case C-221/89 (*Factortame II*), paragraph 20.
[39] Case C-251/98 (*C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*), April 13, 2000, ECR 2000, page I-2787; see with respect to the *Baars* case also Lüdicke, Baars: Weigerung der Anerkennung des Vermögensteuerfreibetrags als Verletzung der Niederlassungsfreiheit, Internationales Steuerrecht 2000, page 337 et seq.; Stangl, Der Begriff der steuerlichen Kohärenz nach den Urteilen Baars und Verkooijen, Steuer und Wirtschaft International 2000, page 463 et seq.; Lupo, Reliefs from Economic Double Taxation on EU Dividends: Impact of the Baars and Verkooijen Cases, European Taxation 2000, page 270 et seq.
[40] Case C-251/98 (*Baars*), paragraph 7.
[41] Case C-251/98 (*Baars*), paragraph 8.
[42] Case C-251/98 *(Baars*), paragraph 20.
[43] Case C-251/98 (*Baars*), paragraph 21.
[44] Case C-251/98 (*Baars*), paragraph 22.
[45] Case C-251/98 (*Baars*), paragraph 26.

the right of establishment of *ICI*, since *ICI* wanted to apply the consortium relief and not the holding company. The Court stated that *"(...) companies established in that State belonging to a consortium through which they exercise their right to freedom of establishment (...)"* [46] From the wording it seems that the "consortium" gives *ICI* the possibility to exercise the right of establishment.[47] If this is the case, certain other legal provisions (e.g. combined organic structures) or even contractual arrangements in which two or more companies exercise their control together should lead to the outcome that each of the participants can claim the right of establishment. It could even be the case that the mere existence of two or more shareholders which together hold the majority of shares can be considered to exercise the right of establishment. In this case, the question arises whether a *minority* shareholder can rely on the freedom of establishment if he holds the shares together with one or more additional shareholders. In principle, there should be no difference between a "consortium" in the sense of the United Kingdom legislation and the mere parallel existence of a number of shareholders which have - combined - a definite influence over the company's decisions. It is also possible that the Court did not see any necessity to doubt that the *ICI* could exercise the right of establishment since *ICI* (or the "consortium") was *directly or indirectly involved in the management* [48] of the subsidiary companies. It should be taken into consideration that the Court described control *or* management (and not control *and* management) as relevant factors for the exercising of the right of establishment.[49] The involvement in the management of a company can, of course, also exist in cases without control. However, this was not the issue in the *Baars* case.

Even though it seems that the outcome of the *ICI* case and the *Baars* case do *not* perfectly fit together, it cannot be overlooked that the Court gave some "instructions" in the latter case, whereas nothing is included in the *ICI* case. Of course, there was no doubt about the question whether Mr. Baars could exercise the right of establishment since he was the 100 percent shareholder of the Irish company.[50] In my opinion, the expression "*definite influence over the company's decisions*" and "*allows him to determine its activities*" have to be seen in the light of the respective commercial law and company law of the respective Member State. I do not think that the Directive 78/660/EEC on accounts and the Directive 83/349/EEC on consolidated accounts can be very helpful in this respect.[51] In his Opinion to the case Advocate General Alber outlined that in his view *"the border between the simple investment of capital in shares in an undertaking established in another Member State, and actual establishment in that Member State, should probably be set at the point where a shareholder ceases to confine himself to the mere provision of capital in support of a particular business activity carried on by another person, and begins to become*

[46] Case C-264/96 (*ICI*), paragraph 30.
[47] According to Daniels, some clarification as to the meaning of being engaged in a consortium would have been useful (see Daniels, The Freedom of Establishment: Some Comments on the *ICI* Decision, EC Tax Review 1999, page 39 et seq. (40).
[48] "*Directly or indirectly involved in the management of the companies*" is the wording which was used by the ECJ in the *Polysar* case (a VAT case) which is outlined below (see case C-60/90 (*Polysar*), paragraph 14).
[49] The reference to control *or* management is not unusual. Article 9 (1) of the OECD-MTC also refers to "management, control or capital of an enterprise."
[50] See in this respect also the Opinion of Advocate General Alber, dated October 14, 1999, paragraph 34.
[51] According to the Directive 78/660/EEC on accounts (Fourth Company Law Directive, dated July 25, 1978) a minimum participation of 20 percent is required in the respective context. The Directive 83/349/EEC on consolidated accounts (Seventh Company Law Directive, dated June 13, 1983) applies to a majority participation or participation that allows control to be exercised over another corporation.

involved himself in conducting the business. Such involvement requires the shareholder to go beyond simply exercising his voting rights, and to participate in a way which will enable him to exercise real influence over the company's business decisions. In determining whether such is the case, regard should be had to the rules of company law in the State in which the undertaking is established." [52] Of course, the reference to the company law of the Member State in question would lead to the outcome that the right of establishment could be applied differently, depending on the domestic provisions in the respective Member State. The predominant opinion in the literature seems to be that reference should be made to secondary EU law.[53] However, the reference to a 20 percent threshold based on Directive 83/349/EEC and Directive 78/660/EEC[54] as well as the 25 percent threshold based on Directive 90/435/EEC (Parent-Subsidiary Directive)[55] do - in my opinion - not comply with the requirements stipulated by the Court in the underlying case, i.e. especially the requirement to have definite influence to determine its activities. In typical cases, a shareholding of more than 50 percent gives the respective majority shareholder the possibility to determine the activities of the company. In cases where the voting rights differ from the shareholding (i.e. majority voting rights but minority shareholding) it seems that the deviating voting rights are decisive. In 50:50 situations (shareholding and / or voting rights) there will in most cases not be a definite influence of one single shareholder (but in combination) since both shareholders are dependent on each other. The definite influence is certainly to be denied in situations with minority shareholdings and minority voting rights, even though there may certainly be cases with a definite influence on a factual or contractual basis (e.g. combined interests).[56] A right to block certain decisions is, as such, not sufficient since it does not lead to a definite influence over the company's decisions.

4.2.1.1.6. The *Überseering* Case

The dependence on the question of a definite influence over the company's decisions was later on confirmed in the *Überseering* case.[57] Without going into detail of the

[52] Opinion of Advocate General Alber, dated October 14, 1999, paragraph 33.
[53] See the references in Cordewener, Europäische Grundfreiheiten und nationales Steuerrecht, page 721, footnote 1231.
[54] Troberg in Groeben / Thiesing / Ehlermann, Kommentar zum EU-/EG-Vertrag, Article 52, paragraph 12 and Article 221, paragraphs 3, 6.
[55] Schön, Gedächtnisschrift für Knobbe-Keuk, page 743 and page 750 et seq.
[56] See in this respect case C-298/05 (*Columbus Container*) which is outlined in more detail below.
[57] Case C-208/00 (*Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)*), November 5, 2002, ECR 2002, page I-09919; see with respect to the *Überseering* case also Thömmes, Klagemöglichkeit ausländischer juristischer Personen vor deutschen Gerichten, Internationale Wirtschafts-Briefe 2002, page 575 et seq.; Thömmes, Beschränkung der Niederlassungsfreiheit: EuGH, Urt. v. 5.11.2002 - Rs. C-208/00 Überseering BV gegen Nordic Construction Company Baumanagement GmbH (NCC), Internationale Wirtschafts-Briefe, Fach 11A, page 623 et seq.; Pache, Die Urteile des BFH und des BGH vom 29.01.2003 als erste Reaktion auf die Überseering-Entscheidung des EuGH, Internationales Steuerrecht 2003, page 808 et seq.; Biebl, Niederlassungsfreiheit und Zuzug doppelt ansässiger Kapitalgesellschaften, Steuer und Wirtschaft International 2003, page 168 et seq.; Weber, Exit Taxes on the Transfer of Seat and the Applicability of the Freedom of Establishment after Überseering, European Taxation 2003, page 350 et seq.; Aigner / Kofler, Steuerliche Folgen des Zuzugs von EU-Kapitalgesellschaften nach Österreich nach der Rechtsprechung des EuGH in der Rs. Überseering (C-208/00), Internationales Steuerrecht 2003, page 570 et seq.; Birk, Zuzug und Wegzug von Kapitalgesellschaften - zu den körperschaftsteuerlichen Folgen der Überseeringentscheidung des EuGH, Internationales Steuerrecht 2003, page 469 et seq.; Haase, Grenzüberschreitende Sitzverlegungen von Kapitalgesellschaften vor und nach dem Urteil des EuGH vom 5.11.2002 (Rs. Überseering), Internationale Wirtschafts-Briefe 2003, Fach 11, Gruppe 2, page 529 et seq.; Deininger, Körperschaftsteuerliche Auswirkungen der Überseering-Entscheidung des EuGH, Internationales Steuerrecht 2003, page 214 et seq.

case itself at this point, it is nevertheless worth having a look at that particular question. From the case it was clear that two German nationals together were the sole shareholders of the Überseering BV.[58] What was not clear from the case and the Opinion of the Advocate General was whether each one of the two shareholders had a percentage of 50 percent or whether there was a deviating participation. However, it seems that this question was not relevant since the Court stated that *"(...) it must be borne in mind that as a general rule the acquisition by one or more natural persons residing in a Member State of shares in a company incorporated and established in another Member State is covered by the Treaty provisions on the free movement of capital, provided that the shareholding does not confer on those natural persons definite influence over the company's decisions and does not allow them to determine its activities. By contrast, where the acquisition involves all the shares in a company having its registered office in another Member State and the shareholding confers a definite influence over the company's decisions and allows the shareholders to determine its activities, it is the Treaty provisions on freedom of establishment which apply."* [59] The Court concluded that the freedom of establishment could be relied on in the underlying case. The statement shows that the Court does not restrict the application of the freedom of establishment to the definite influence of one single shareholder but considers that both shareholders can exercise the freedom of establishment together. It seems to be sufficient that both shareholders together have the required definite influence. Taking into consideration the outcome of the *ICI* case, it should theoretically be possible that each one of the two shareholders could separately rely on the freedom of establishment.

4.2.1.1.7. The *Leur-Bloem* Case

Since it can be learned from *Factortame* that the *"actual pursuit of an economic activity"* is a precondition to come into the scope of the freedom of establishment, it could be of some interest to have a look at the *Leur-Bloem* decision.[60] The *Leur-Bloem* case deals with secondary EU Law, namely the Merger Directive, and the question of the interpretation of Dutch law (and *not* with questions related to the freedom of establishment). However, it could be of some relevance here that a newly-incorporated holding company - without any business activity - was involved in a proposed operation. According to the plan of Mrs. Leur-Bloem, the shares in two Dutch companies should be transferred to a Dutch holding company in exchange for a number of own shares of the holding company.[61] Dutch law provided for a deferment of taxation in a situation in which "*a company established in the Netherlands acquires, in return for the transfer of a number of shares together in some cases with an additional payment, possession of a number of shares of another company established in the Netherlands permitting it to exercise more than half of the voting rights in the latter company, with a view to combining in a single unit, on a*

[58] Case C-208/00 (*Überseering*), paragraph 7.
[59] Case C-208/00 (*Überseering*), paragraph 77.
[60] Case C-28/95 (*A. Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen Amsterdam 2*), July 17, 1997, ECR 1997 page I-04161; see with respect to the *Leur-Bloem* case also Hoenjet, The Leur-Bloem Judgement: The Jurisdiction of the European Court of Justice and the Interpretation of the Anti-Abuse Clause in the Merger Directive, EC Tax Review 1997, page 206 et seq.; Bruin / Molenaars, European Court of Justice Hands Down Decision on EU Merger Directive, Tax Notes International 1997, page 424 et seq.; Liebman, Ruling on Merger Directive, European Taxation 1997, pages 462, 463; Stevens, Blumen aus Holland? - Auswirkungen der Leur-Bloem-Entscheidung auf das niederländische Umwandlungssteuerrecht, Internationales Steuerrecht 1998, page 201 et seq.
[61] See case C-28/95 (*Leur-Bloem*), paragraph 3.

permanent basis from an economic and financial viewpoint, the undertaking of the acquiring company and that of another person." [62] Parallel to this purely domestic exchange of shares an intra-EU share-for-share exchange, with the same requirements, was implemented in Dutch law, too, in order to fulfil the obligation of implementing the Merger Directive into domestic law.[63] Pursuant to the ECJ, the term *"undertaking" within the meaning of the Netherlands Law must in substance be understood as the economic activity of a legal person, the term "company" referring to the legal personality."* [64] There are two features which are of particular interest: (i) the term "undertaking" is defined as the economic activity of a legal person, and (ii) both companies are required to combine their "undertaking," which consequently prerequisites that both companies pursue an economic activity.

It is important to know that the domestic condition *"with a view of combining in a single unit, on a permanent basis from an economic and financial viewpoint, the undertaking of the acquiring company and that of another person"* was added by the Dutch legislature and is not included in Article 2 (d) of the Merger Directive. The condition was added in order to prevent, pursuant to Article 11 of the Merger Directive, the tax advantages which the Merger Directive provides from being granted for operations having as their principal objective tax evasion or tax avoidance.[65] The Court made it clear that Article 2 (d) of the Merger Directive applies without distinction to all exchanges of shares, irrespective of the reasons, whether financial, economic or simply fiscal.[66] The fact that the acquiring company does not itself carry on a business does not prevent the operation from being treated as an exchange of shares within the meaning of Article 2 (d) of the Merger Directive.[67] In order to determine whether the objective of the planned operation is tax evasion or tax avoidance, the competent national authorities cannot confine themselves to applying predetermined general criteria, but must carry out a general examination in each particular case.[68] The involvement of a newly-created holding company which "*does not therefore have any business"* does not imply that no valid commercial reasons exist.[69] The domestic provision, which indirectly requires an economic activity of the holding company - since *two undertakings* have to be combined in a single unit - is not in line with the Merger Directive. It is not clear whether the holding of shares - after the restructuring - would be considered to be a business activity. It can be understood from the case that due to the fact that the holding company was just incorporated a business activity does not (*"therefore")* exist. In any case, it is clear that no business activity of the holding company is required by the Merger Directive - and it cannot be required by Dutch law - for the planned operation. If valid commercial reasons for the operation exist, a business activity of the holding company will not even be required after the transaction is executed.

The *actual pursuit of an economic activity* which is a precondition to come within the scope of the freedom of establishment is not a precondition for the acquiring company under the Merger Directive. This can very well be the case since the requirements in order to apply the right of establishment do not need to coincide with

[62] Article 14 b (2) (a) of the Netherlands Income Tax Act of 1964; see Case C-28/95 (*Leur-Bloem*), paragraph 5.
[63] Article 14 b (2) (b) of the Netherlands Income Tax Act of 1964; see Case C-28/95 (*Leur-Bloem*), paragraph 5.
[64] Case C-28/95 (*Leur-Bloem*), paragraph 6.
[65] Case C-28/95 (*Leur-Bloem*), paragraph 35.
[66] Case C-28/95 (*Leur-Bloem*), paragraph 36. The same is true for mergers, divisions, and the transfer of assets.
[67] Case C-28/95 (*Leur-Bloem*), paragraph 37.
[68] Case C-28/95 (*Leur-Bloem*), paragraph 41.
[69] Case C-28/95 (*Leur-Bloem*), paragraph 42.

the requirements under the Merger Directive. Pursuant to *Kemmeren*, a directive can confer rights upon a person who would otherwise not be subject to EC law (now EU law).[70] Nevertheless, it is in my opinion instructive that the Court linked the meaning of the term "undertaking" in Dutch law with the pursuit of an economic activity. The same was done by the Court in the *Job Centre* case[71] where the Court pointed out that *"it must be observed, in the context of competition law, first, that the concept of an undertaking encompasses every entity engaged in an economic activity, regardless of its status and the way in which it is financed and, second, that the placement of employees is an economic activity."* [72] It is clear from the statements that "undertaking" and "economic activity" are connected, but it is also clear from the statements, in my opinion, that not each and every activity of a legal entity is an economic activity.

4.2.1.1.8. The *Cadbury Schweppes* Case

Without any doubts, the *Cadbury Schweppes* case[73] is one of those cases which are of particular importance in the context of this study since it is the first decision of the ECJ which explicitly deals with the application of the CFC rules of one Member State in relation to a secondary establishment in another Member State. However, in order to avoid an overlapping with chapter 8 - where the important elements of the case will be examined - I will not describe the *Cadbury Schweppes* case in this chapter. Nonetheless, in the following I will refer to elements of the case whenever it is need to determine the scope of the freedom of establishment in order to have a complete picture and a basis for the verifications in chapter 8.

[70] Kemmeren, Principle of Origin in Tax Conventions - A Rethinking of Models, page 185.
[71] Case C-55/96 (*Job Centre coop. arl.*), December 11, 1997, ECR 1997 page I-07119.
[72] Case C-55/96 (*Job Centre*), paragraph 21; see also Kemmeren, Principle of Origin in Tax Conventions - A Rethinking of Models, page 184 and Footnote 339.
[73] Case C-196/04 (*Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*), September 12, 2006, ECR 2006. See with respect to the *Cadbury Schweppes* case the references included in chapter 8 and in the bibliography.

4.2.1.1.9. The *Columbus Container* Case

The *Columbus Container* decision[74] is another decision which - at least indirectly - deals with CFC legislation. The national measure which was subject to verification by the ECJ was section 20 (2) and (3) of the German *Außensteuergesetz* (AStG). Based on this legislation, the double taxation of income derived through a foreign permanent establishment will - under certain circumstances - be avoided by the application of the credit method instead of the exemption method. The rules even apply in cases in which the double tax convention concluded between Germany and the state of the permanent establishment considers, in principle, the application of the exemption method for income derived through the permanent establishment. The legislation can therefore result in a treaty-override. In short, the requirements for the general application of the credit method - and therefore also for the possible switch-over from the exemption method to the credit method - are as follows:[75]

- the foreign permanent establishment of a person with unlimited liability to tax in Germany derives passive income within the meaning of the second sentence of section 10 (6) AStG; and

- the passive income would be liable to tax as CFC income if that establishment were a foreign corporation.

Passive controlled-foreign-corporation income in the sense of section 10 (6) AStG means income which is derived from holding, administering, maintaining or

[74] Case C-298/05 (*Columbus Container Services BVBA & Co v Finanzamt Bielefeld-Innenstadt*), December 6, 2007. See with respect to the *Columbus Container* case also Schnitger, Par. 20 Abs. 2 und 3 AStG a.F. vor dem EuGH - Meistbegünstigung "Reloaded"?, Finanz-Rundschau 2005, page 1079 et seq.; Wimpissinger, Gemeinschaftsrechtswidrigkeit der Hinzurechnungsbesteuerung ausländischer Betriebsstätteneinkünfte in Deutschland: Neue Erkenntnisse aus Cadbury Schweppes für Columbus Container?, Steuer und Wirtschaft International 2006, page 559 et seq.; Lüdicke, Pending Cases Filed by German Courts I: Kolumbus Container Services Case, in ECJ - Recent Developments in Direct Taxation 2006, page 163 et seq.; Schnitger, German CFC Legislation Pending before the European Court of Justice - Abuse of the Law and Revival of the Most-Favoured-Nation-Clause?, EC Tax Review 2006, page 151 et seq.; Franck, § 20 Abs. 2 AStG auf dem Prüfstand der Grundfreiheiten - Anmerkung zu den Schlussanträgen des Generalanwalts Mengozzi in der Rechtssache C-298/05 (*Columbus*), Internationales Steuerrecht 2007, page 489 et seq.; Cloer / Lavrelashvili / Biebl, Rechtssache Columbus: Unilateraler Switch-over im Fokus des Gemeinschaftsrechts, Steuer und Wirtschaft International 2007, page 359 et seq.; Niederlassungs- und Kapitalverkehrsfreiheit: darf ein Mitgliedstaat einseitig die in einem DBA vorgesehene Freistellungs- durch die Anrechnungsmethode ersetzen (Par. 20 Abs. 2, 3 AStG)? - Schlussanträge „Columbus Container Services", in Europäisches Wirtschafts- und Steuerrecht 2007, page 221 et seq.; Rainer, Columbus Container: Belgisches Koordinierungszentrum und AStG, Internationales Steuerrecht 2008, page 63 et seq.; Thömmes, Übergang zur Hinzurechnungsmethode bei Betriebsstätten EG-rechtskonform, Internationale Wirtschafts-Briefe 2008, Fach 11A, page 1169 et seq.; Meussen, Columbus Container Services: A Victory for the Member States' Fiscal Autonomy, European Taxation 2008, page 169 et seq.; Kessler / Eicke, The Egg of Columbus Container: German Buget Sunny Side Up, Not Scrambled, Tax Notes International 2008, page 587 et seq.; Morgan / Bridges, Columbus Container Services, The Tax Journal 2008, pages 15, 16.

[75] Section 20 (2) AStG; Pistone, Ups and Downs in the Case Law of the European Court of Justice and the Swinging Pendulum of Direct Taxation, Intertax 2008, page 146 et seq.; Opinion Statement of the CFE ECJ Task Force on ECJ, *Columbus Container Services BVBA & Co v. Finanzamt Bielefeld-Innenstadt*, 6 December 2007, C-298/05 - April 2008, European Taxation 2008, page 541 et seq.; Weber, ECJ holds German Credit System on Foreign Income Following a "Treaty Override" Compatible with EC Law (*Columbus Container Services*), January 2008; Müller, ECJ Case Relating to the Recapture of Cross Border Loss Incurred by a Foreign PE, European Tax Service, November 2008; Calderón / Baez, *The Columbus Container Services* ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle, Intertax 2009, page 212 et seq.

increasing the value of payment media, receivables, securities, investments and similar assets. For the application of the German CFC legislation to income realised by a foreign legal entity, the income must be subject to low taxation, i.e. less than 30 percent.[76] By the stipulation of the link in section 20 (2) and (3) AStG to the "regular" CFC legislation it is clear that the rules will only apply to low-taxed income.

In the underlying case, a Belgian limited partnership acted as a coordinator of activities within an international group (Belgian coordination centre) and was responsible, in particular, for the centralisation of financial transactions and of the accounts, the financing of the liquidity of subsidiaries or branches, the computerisation of data and advertising and marketing services. The shares in the Belgian limited partnership were held by eight members of the same family residing in Germany, each member having a 10 percent holding. The remaining 20 percent of the shares were held by a German partnership which, in turn, was held by members of the aforementioned family. At Columbus' general meeting, all shareholders were represented by the same person.[77] Columbus' economic activities centred on the management of designated passive income within the meaning of section 10 (6) AStG. Moreover, the income derived by through the partnership was subject to low taxation - due to the coordination centre regime. The Belgian partnership was considered to be transparent from a German tax perspective. Thus, since the requirements of section 20 (2) AStG were fulfilled for most of the income derived by the partnership, the passive income was allocated to the German resident partners and the double taxation of passive income had to be avoided according to the credit method and not according to the exemption method (which otherwise would have been the case without section 20 (2) AStG). [78]

The question referred to the ECJ for a preliminary ruling by the German court was, in essence, whether section 20 (2) and (3) AStG was contrary to Article 49 of the TFEU and Articles 63-65 of the TFEU.[79] While examining the existence of a restriction on the freedom of establishment, the ECJ made a statement which, in my opinion, can be helpful for the further differentiation between the scope of the freedom of establishment and the free movement of capital. The ECJ held that *"(…) the acquisition by one or more natural persons residing in a Member State of all the shares in a company registered in another Member State, conferring on those persons definite influence over the company's decisions and allowing them to determine its activities, is thus covered by the Treaty provisions on the freedom of establishment (…). In the present case, it is apparent (…) that all shares in Columbus are held, either directly or indirectly, by members of one family. The latter pursue the same interests, take decisions concerning Columbus by agreement through the same representative at the general meeting of Columbus and decide on its activities. It follows that the Treaty provisions on the freedom of establishment apply to a situation such as that in the main proceedings."*[80] Thus, even a participation of 10 to 12.50 percent[81] can be within the scope of the freedom of establishment as long as the majority of shareholders have the same interest and, therefore, the shareholding

[76] The low-taxation threshold of 30 percent which was applicable in 1996 was later on reduced to 25 percent.
[77] Case C-298/05 (*Columbus Container*), paragraphs 13 to 16.
[78] Case C-298/05 (*Columbus Container*), paragraphs 17 to 19.
[79] Case C-298/05 (*Columbus Container*), paragraph 25.
[80] Case C-298/05 (*Columbus Container*), paragraphs 30 to 32.
[81] The direct participation of 10 percent of each of the individual family members is clear from the case. What is not completely clear is the indirect participation (through the German partnership). However, mathematically the participation of *some* of the family members should be between 10 percent and 12.50 percent.

confers definite influence over the company's decisions. The fact that the shareholders had the same representative at the general meeting, of course, supported this conclusion.

4.2.1.1.10. The *Société de Gestion Industrielle (SGI)* Case

The *SGI* decision[82] is a further step towards a better understanding of the requirement of having a 'definite influence' over the company's decisions. In this case, a company incorporated under Luxembourg law (*Cobelpin*) held 34 percent of the shares in *SGI*. *Cobelpin* was also director and managing director of *SGI*.[83] In addition, an individual person (*Mr. Leone*) was managing director of *SGI* and a director of *Cobelpin* as well as a director of a subsidiary company of *SGI*.[84] While examining whether the respective investment comes within the scope of the freedom of establishment, the ECJ concluded - with reference to the *Baars* case-law - that "*such holdings*" are, "*in principle*", capable of giving *Cobelpin* definite influence over the decisions and activities of *SGI*.[85] Based on the latter statement, one could conclude that a shareholding of 34 percent is sufficient to confer definite influence and, therefore, to come within the scope of the freedom of establishment. However, it has to be noted that the ECJ added that there were also *"(…) links between those companies at management level."*[86] The latter part brings uncertainty to the question whether the 34 percent shareholding as such, i.e. without considering the links on the management level, would have been sufficient for the conclusion that a definite influence exists.[87] I think it is sufficient, because the statement "*such holdings*" referred to paragraph 34 of the decision where only the shareholding was outlined, without any reference to the management links.[88]

4.2.1.2. Economic Activity and the Freedom of Establishment

The ECJ defined the concept of establishment in the *Factortame* decision as the "*actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period."*[89] There are basically four important elements included in this statement: (i) actual pursuit of an economic activity (ii) through a fixed establishment (iii) in another Member State (iv) for an indefinite period. The third and

[82] Case C-311/08 (*Société de Gestion Industrielle SA (SGI) v État belge*), January 21, 2010. See with respect to the *SGI* case also Jiménez, Transfer Pricing and EU Law Following the ECJ Judgement in *SGI*: Some Thoughts on Controversial Issues, Bulletin for International Taxation 2010, page 271 et seq.; Meussen, The *SGI* Case: ECJ Approves Belgian System of Selective Profit Corrections in Relation to Foreign Group Companies, European Taxation 2010, page 245 et seq.; Den Boer, Freedom of Establishment versus Free Movement of Capital: Ongoing Confusion at the ECJ and in the National Courts?, European Taxation 2010, page 250 et seq.; Dodwell, ECJ Rules on Belgian Anti-Abuse Rule on Exceptional and Gratuitous Advantages, Intertax 2010, pages 253, 254; Thömmes, Gewinnkorrektur bei Vorteilsgewährung an verbundene Unternehmen im EU-Ausland, Internationale Wirtschafts-Briefe 2010, page 107 et seq.; Englisch, Einige Schlussfolgerungen zur Grundfreiheitskompatibilität des § 1 AStG - zugleich Anmerkungen zum Urteil des EuGH in der Rs. *SGI*, Internationales Steuerrecht 2010, page 139 et seq.; Becker / Sydow, Das EuGH-Urteil in der belgischen Rechtssache C-311/08 *SGI* und seine Implikationen für die Frage der Europarechtmäßigkeit des § 1 AStG, Internationales Steuerrecht 2010, page 195 et seq.
[83] Case C-311/08 (*SGI*), paragraph 10.
[84] Case C-311/08 (*SGI*), paragraph 11.
[85] Case C-311/08 (*SGI*), paragraph 35.
[86] Case C-311/08 (*SGI*), paragraph 35.
[87] See in this regard also Den Boer, Freedom of Establishment versus Free Movement of Capital: Ongoing Confusion at the ECJ and in the National Courts?, European Taxation 2010, page 250 et seq. (253).
[88] Case C-311/08 (*SGI*), paragraphs 34, 35.
[89] Case C-221/89 (*Factortame II*), paragraph 20.

fourth element "another Member State" and "indefinite period" seems to be relatively clear and allows the participation, on a stable and continuous basis, in the economic life of a Member State other than his State of origin. [90] This should basically give an individual or a company the possibility to pursue its activities in the Member State of the secondary establishment in the same way as in the Member State of origin. However, such a degree of integration can only be achieved if the activity is not only exercised on a temporary basis. The second element "fixed establishment" will be discussed separately. The first element, however, needs additional investigation in order to find out what is actually meant by "economic activity" in the context of the freedom of establishment.

The existing case law, especially the *Factortame* decision, can be very helpful in this respect. The Court concluded that the vessel *"does not necessarily involve establishment within the meaning of the Treaty, in particular where the vessel is not used to pursue an economic activity."* [91] However, the vessel can constitute *"an instrument for pursuing an economic activity."* [92] As already outlined above, the *instrument* vessel can easily be replaced by other assets.[93] In my opinion, tangible or intangible assets cannot *by themselves* create an economic activity. The assets must (i) directly or indirectly be *utilised* to pursue an activity, and (ii) the activity itself must be an *economic* activity. In the same way as a vessel may theoretically be registered without pursuing any economic activity, a company can hold any kind of assets without utilising them at all, or without utilising them for economic but other activities. In contrast, it is theoretically possible to pursue an economic activity without utilising any assets or with a very limited utilisation of assets, but it will not be possible to pursue an economic activity without performing any activity, i.e. simply by holding assets.

4.2.1.2.1. Economic Activity and Indirect Taxation

In order to clarify what is actually meant by economic activity, it could be helpful to have a look at the VAT system in the EU. Article 9 paragraph 1 of the Council Directive 2006/112/EC (which replaced Article 4 (1) and (2) of the 6th VAT Directive) [94] states that "*taxable person*" in the sense of the VAT system shall mean *"any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity. Any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of professions, shall be regarded as 'economic activity'. The exploitation of tangible and intangible property for the purpose of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity."* [95] According to Article 12 paragraph 1 a Member State may also treat as a taxable person anyone who carries out, on an occasional basis, a transaction relating to the activities referred to in the second subparagraph of Article 9 paragraph 1 and - under certain circumstances - the supply of buildings and land.[96] Pursuant to this definition

[90] Case C-55/95 (*Gebhard*), paragraph 25.
[91] Case C-221/89 *(Factortame II*), paragraph 21.
[92] Case C-221/89 *(Factortame II*), paragraph 22.
[93] In my opinion, there are certain assets which are relevant in this context, since they can be an instrument to pursue an economic activity. Liabilities are only the consequence of the activity itself or the consequence of the re-financing of the assets.
[94] Council Directive 2006/112/EC, dated November 28, 2006 on the common system of value added tax.
[95] Article 9 paragraph 1 first and second subparagraphs of the Council Directive 2006/112/EC.
[96] Article 12 paragraph 1 of the Council Directive 2006/112/EC.

economic activity not only encompasses the activities of producers, traders and the supply of services, but also the exploitation of tangible or intangible property. The latter can be a typical activity which is often qualified as a passive activity in the context of CFC legislation. It is required, however, that the exploitation is carried out with the purpose of obtaining income on a continuing basis. The second subparagraph of Article 9 paragraph 1 includes just a typological description of economic activities. It is therefore important to verify existing VAT case law in order to clarify the term "economic activities."

In the *Hong-Kong* case,[97] the Amsterdam office of the Hong-Kong Trade Development Council claimed to be a taxable person, even though the Trade Council provided only services which were free of charge.[98] The Court took the opportunity to describe the VAT system of neutrality and made it clear that *"(t)he requirement that taxable transactions must be effected against payment is confirmed by the fact that the economic activities of taxable persons (...) are necessarily activities which are carried on with the object of obtaining payment of consideration (…), because if they are free of charge in all cases they do not fall within the system of value added tax (…)."*[99] It is clear from subsequent case law of the ECJ that a supply of services "for consideration" is taxable *"(...) only if there is a legal relationship between the provider of the service and the recipient pursuant to which there is a reciprocal performance, the remuneration received by the provider of the service constituting the value actually given in return for the service supplied to the recipient."*[100] These statements are also of particular interest with respect to the "holding cases" below and the question how "direct or indirect involvement in the management" has to be understood. The *Enkler* case[101] shows that the hiring out of tangible property[102] must be regarded as an "exploitation" of such property within the meaning of the second sentence of Article 4 (2) of the 6th VAT Directive and not as a supply of services within the meaning of the first sentence of Article 4 (2) of the 6th VAT Directive.[103] The hiring out of tangible property constitutes exploitation of such property and must therefore be classified as an "economic activity" if it is done for the purpose of obtaining income therefrom on a continuing basis.[104] The Court stated that pursuant to Article 4 (1) of the 6th VAT Directive[105], the purpose and the results of the activity were irrelevant as such for the purposes of determining the scope of the Directive[106]

[97] Case 89/81 (*Staatssecretaris van Financien v Hong-Kong Trade Development Council*), April 1, 1982, ECR 1982, page 01277.
[98] The Hong-Kong Trade Development Council provided - free of charge - traders with information and advice about Hong Kong and the opportunities for trade with Hong Kong. The income of the office was provided in the form of a fixed annual grant from the Hong Kong Government and from the proceeds of a charge amounting to 0.5% of the value of the products imported into and exported from Hong Kong (Case C 89/81 (*Hong-Kong*), paragraph 2).
[99] Case 89/81 (*Hong-Kong*), paragraph 11.
[100] Case C-16/93 (*Tolsma*), ECR 1994, page I-743, paragraph 14; case C-2/95 (*SDC*), ECR 1997, page I-3017, paragraph 45; case C-305/91 (*Finanzamt Groß-Gerau v MKG-Kraftfahrzeuge-Factoring GmbH*), June 26, 2003, ECR 2003, page I-06729, paragraph 47.
[101] Case C-230/94 (*Renate Enkler v Finanzamt Homburg*), September 26, 1996, ECR 1996, page I-04517. See with respect to this case also Beiser, Die "kleine Vermietung" in der Umsatz- und Einkommensteuer: eine gemeinschaftsrechtliche und verfassungsrechtliche Analyse, in Steuer und Wirtschaftskartei 2006, page 666 et seq.
[102] In this case a motor caravan.
[103] Now Article 9 (1) subparagraph 2 of the Council Directive 2006/112/EC. See case C-230/94 (*Enkler*), paragraph 21.
[104] Case C-230/94 (*Enkler*), paragraph 22.
[105] Now Article 9 (1)subparagraph 1 of the Council Directive 2006/112/EC.
[106] Case C-230/94 (*Enkler*), paragraph 25.

and that "*one of the factors on the basis of which the tax authorities must consider whether a taxable person has acquired goods for the purposes of his economic activities is the nature of the goods concerned*." [107] And "*(t)he fact that property is suitable only for economic exploitation will normally be sufficient to find that its owner is exploiting it for the purposes of his economic activities (…).* If the property can be used for economic and private purposes, the circumstances have to be examined in order to determine whether it is actually used for the purpose of obtaining income on a regular basis.[108] From the *Rompelman* case[109] it can be learned that if someone plans to pursue an economic activity, even preparatory activities in an early stage will be attracted to the (future) economic activity.[110]

The first case which dealt with the question of a holding company as a taxable person in the sense of Article 4 of the 6th VAT Directive,[111] and therefore also with the question of economic activity, was the *Polysar* case.[112] The Dutch holding company *Polysar BV* received dividends on a yearly basis but was not engaged in trading activities.[113] Based on the judgement of the ECJ in the *Van Tiem* decision,[114] Article 4 confers a very wide scope on VAT. The "exploitation" of tangible or intangible property within the meaning of Article 4 (2) refers to all transactions, irrespective of the legal form, which are carried out for the purpose of obtaining income on a continuing basis.[115] However, it does not follow from that decision that *"the mere acquisition and holding of shares in a company is to be regarded as an economic activity, within the meaning of the Sixth Directive, conferring on the holder the status of a taxable person. The mere acquisition of financial holdings in other undertakings does not amount to the exploitation of property for the purpose of obtaining income therefrom on a continuing basis because any dividend yielded by that holding is merely the result of ownership of the property."* [116] Interestingly, the Court went on to state that *"(i)t is otherwise where the holding is accompanied by direct or indirect involvement in the management of the companies in which the holding has been acquired, without prejudice to the rights held by the holding company as shareholder."* [117] The conclusion and the answer to the question is therefore that a holding company the (actual) activity of which is limited to the acquisition of holdings in undertakings, without being directly or indirectly involved in the management of those undertakings, does not have the status of a taxable person for the purpose of VAT.[118] In my opinion, the fact that the acquisition of financial

[107] Case C-230/94 (*Enkler*), paragraph 26; see also case C-97/90 (*Lennartz v Finanzamt Muenchen III*), ECR 1991, page I-3795.
[108] Case C-230/94 (*Enkler*), paragraph 27.
[109] Case C 268/83 (*D.A. Rompelman and E.A. Rompelman-Van Deelen v Minister van Financien*), February 14, 1985, ECR 1985, page 00655.
[110] Case C 268/83 (*Rompelman*), paragraph 25.
[111] Now Article 9 (1) of the Council Directive 2006/112/EC.
[112] Case C-60/90 (*Polysar Investments Netherlands BV v Inspecteur der Invoerrechten en Accijnzen*), June 20, 1991, ECR 1991, page I-03111. See with respect to this case also Farmer, Taxable Persons and the "Private Life" of Companies, The EC Tax Journal 1997, page 41 et seq.
[113] Case C-60/90 (*Polysar*), paragraph 6.
[114] Case C-186/89 (*Van Tiem v Staatssecretaris van Financien*), December 4, 1990, ECR 1990, page I-4363. See with respect to this case also Thiel, Deductibility of Input Tax: Concept of Taxable Person and Taxable Supply under the Sixth VAT Directive, International VAT Monitor 1991, page 18 et seq.
[115] Case C-60/90 (*Polysar*), paragraph 12.
[116] Case C-60/90 (*Polysar*), paragraph 13; see also the later case C-333/91 (*Sofitam SA* (*anciennement Satam SA) v Ministre charge du Budget*), June 22, 1993, ECR 1993, page I-03513, paragraphs 12 and 13.
[117] Case C-60/90 (*Polysar*), paragraph 14.
[118] Case C-60/90 (*Polysar*), paragraph 17.

holdings and the dividends received from these financial holdings are not directly related in the sense of a consideration for an exploitation of property is obvious. The exploitation of property or the supply of services and goods must be directly linked to the consideration paid for the exploitation or the supply of services and goods.[119] The *Polysar* case was considered a landmark decision with a determinant role on the outcome of the subsequent cases on the VAT treatment of shares, but was also criticised because of the minimal level of arguments put forward by the ECJ to support its decision.[120]

The statement of the ECJ with respect to the "*direct or indirect involvement in the management of the companies"* is not obvious. The holding company can therefore become a taxable person if there is a certain degree of involvement in the management. It is questionable whether the "involvement" itself requires economic activities which are rendered for a consideration, e.g. management services or similar services,[121] as it is stipulated in Article 2 and 4 of the 6. VAT Directive.[122] This would - at least to that extent - lead to the result that the holding company is a taxable person for VAT purposes.[123] The term "*indirect involvement*" could also be understood in a way that no consideration is necessary, for example an involvement in the form of guidelines for the subsidiary, and it should not be seen very strict and together with the very wide scope conferred by Article 4 of the 6. VAT Directive.[124] Pursuant to *Stadie* it should therefore be sufficient that the holding company controls the subsidiary, i.e. a management contract etc. is not even necessary.[125] If the holding company exercises control only with respect to certain companies but not with respect to all companies, the taxable activity has to be separated for VAT purposes.[126] The ECJ had to deal with these questions in the *Floridienne and Berginvest* case[127], the *Welthgrove* case[128] and the *Cibo Participations* case[129] which will be outlined below.

---

[119] See also BFH, dated May 7, 1981, BStBl. II page 495; BFH, dated January 30, 1997, BStBl. II page 335; case C-142/99 (*Floridienne and Berginvest*), paragraphs 20 and 21; case C-288/94 (*Argos Distributors v Commissioners of Customs and Excise)*, ECR I-5311, paragraph 16; case 154/80 (*Staatssecretaris van Financien v Cooperatieve Aardappelenbewaarplaats)*, ECR 445, paragraph 12; see also case C-16/93 (*Tolsma*), paragraphs 13 and 14 and case C-2/95 (*SDC*), paragraph 45; C-305/01 (*MKG-Kraftfahrzeuge-Factoring GmbH*), paragraph 47.

[120] See in this respect de la Feria, When do Dealings in Shares Fall within the Scope of VAT?, EC Tax Review 2008, page 24 et seq. (25, 26); Terra / Kajus, A Guide to the European VAT Directives - Introduction to European VAT Directive and other taxes, IBFD, 2004, page 816; Farmer, Taxable Persons and the 'Private Life' of Companies, EC Tax Journal 1997, page 41 et seq. (42).

[121] See for example Georgy in Plückebaum / Malitzky, Umsatzsteuergesetz, 1998, paragraph 2, section 216.

[122] Now Articles 2 and 9 (1) of the Council Directive 2006/112/EC.

[123] Heidner in Bunjes / Geist, Umsatzsteuer Kommentar, 7. Auflage, paragraph 2, section 53. According to Heidner, there must be a supply of goods or services to the subsidiary for a consideration in order to come (insofar) to a "taxable person."

[124] See in this respect also BFH, dated July 30, 1992 – V R 95/87, BFH/NV 1993 page 202.

[125] Stadie in Rau / Dürrwächter, Umsatzsteuer Kommentar, paragraph 2, section 208.

[126] Stadie, paragraph 2, section 209.

[127] Case C-142/99 (*Floridienne SA and Berginvest SA v Belgian State*), November 14, 2000, ECR 2000, page I-09567.

[128] Case C-102/00 (*Welthgrove BV v Staatssecretaris van Financien*), July 12, 2001, ECR 2001, page I-05679. See with respect to this case also Farmer, Taxable Persons and the 'Private Life' of Companies, The EC Tax Journal 1997, page 41 et seq.

[129] Case C-16/00 (*Cibo Participations SA v Directeur régional des impots du Nord-Pas-de-Calais*), September 27, 2001, ECR 2001, page I-06663.

The aforementioned differentiation was also relevant in the *Wellcome Trust* case[130] where the ECJ had to decide on the question whether the term "economic activities" in Article 4 (2) of the 6. VAT Directive[131] was capable of covering the sale of shares and securities by a person who was not a dealer in shares and securities and the question whether a large number of share sales and purchases, combined with sophisticated preparation over a considerable period of time, could in itself constitute "economic activities."[132] In the underlying case, the *Wellcome Trust Ltd*. acted as the sole trustee for the *Wellcome Trust*, a charitable trust. In the course of its activities the Trust purchased and sold shares and securities, received dividends from its shareholdings and earned interest income from securities, cash balances and direct bank loans to institutions and banks. The trust also made investments in futures and options in order to hedge its positions. Moreover, the Trust executed a sale of a large stake in a company by way of a public offering which involved a long period of planning and considerable fees for the services of lawyers, financial consultants and public-relations experts.[133] However, the trustee was required to make all reasonable efforts to avoid engaging in trade when exercising the investment powers.[134] The Trust's Director of Finance monitored all portfolios in order to make sure that the Trust did not accidentally acquire a reportable interest in any company.[135] Based on former case law the Court confirmed the very wide scope on VAT,[136] but the mere exercise of the right of ownership by its holder could not, in itself, be regarded as an economic activity.[137] If such activities do not in themselves constitute an economic activity within the meaning of the Directive, the same must be true for activities consisting of the sale of such holdings.[138] The transactions in shares and securities may fall within the scope of the VAT in case such transactions are effected as part of a commercial share-dealing activity[139] or in order to secure a direct or indirect involvement in the management of the companies in which the holding has been acquired.[140]

Subsequent case law shows what is actually meant by the direct or indirect involvement in the management of the subsidiary and to which extent it can basically lead to an economic activity of the holding company. In the *Floridienne and Berginvest* case[141] a holding company (and an intermediary holding company) claimed to be directly or indirectly involved in the management of the subsidiaries, in particular by supplying them with administrative, accounting and information

[130] Case C-155/94 (*Wellcome Trust Ltd. v Commissioners of Customs and Excise*), June 20, 1996, ECR 1996, page I-03013.
[131] Now Article 9 (1) of the Council Directive 2006/112/EC.
[132] Case C-155/94 (*Wellcome Trust*), paragraph 20.
[133] Case C-155/94 (*Wellcome Trust*), paragraph 10.
[134] Case C-155/94 (*Wellcome Trust*), paragraph 7.
[135] Case C-155/94 (*Wellcome Trust*), paragraph 12.
[136] Case C-155/94 (*Wellcome Trust*), paragraph 31; case C-60/90 (*Polysar*), paragraph 12.
[137] Case C-155/94 (*Wellcome Trust*), paragraph 32; case C-60/90 (*Polysar*), paragraph 13; case C-333/91 (*Sofitam*), paragraph 12.
[138] Case C-155/94 (*Wellcome Trust*), paragraph 33. See in this respect also case C-435/05 (*Investrand*), paragraph 25.
[139] This was subsequently confirmed in case C-77/01 (*EDM*). In this decision, the ECJ held that such transactions require the drawing of revenues "*on a continuing basis from activities which go beyond the compass of the simple acquisition and sale of securities (…)"* (case C-77/01 (*EDM*), paragraph 59).
[140] Case C-155/94 (*Wellcome Trust*), paragraph 35; case C-60/90 (*Polysar*), paragraph 14. The outcome was subsequently confirmed - with respect to bonds and shares - in case C-80/95 (*Harnas & Helm CV v Staatssecretaris van Financien*), February 6, 1997, ECR 1997, page I-00745.
[141] Case C-142/99 (*Floridienne and Berginvest*).

technology services and with loan finance. Furthermore, both companies received dividends from their subsidiaries and interest on the loan.[142] It is quite clear that the supply of administrative, accounting and information technology services for consideration was regarded by the Court as an economic activity within the meaning of Article 4 (2) and Article 2 of the 6. VAT Directive. The dividends, however, cannot be regarded as a consideration for the economic activity in question since there is no direct link between the activity carried out and the dividends received. Such a direct link is required in order to fall within the scope of the VAT.[143] Moreover, the Court made it clear that there are additional features underlying the exclusion from VAT and the non-existence of a link to the supply of services: A dividend payment is dependent on unknown factors like the year-end results of the company and the proportions in which the dividend is distributed are normally determined by the shares held and the classes of shares. Dividends represent the return on investment in a company and are merely the result of the ownership of that property.[144] The dividend payments can therefore not be seen as (additional) contributions for the management services rendered by the holding companies. The same is basically true for the interest payments. The two companies merely reinvested the dividends paid by their subsidiaries in loans to some of those subsidiaries without there being any link with the management services. The interest on the loan constitutes income resulting from the ownership of the debts owed by the subsidiaries (or, alternatively, income from credit transactions incidental to the main activity, namely the holding of shares).[145]

There is a very limited possibility that the income from loan comes into the scope of the VAT. This could be the case if it either constituted in itself an economic activity within the meaning of Article 4 (2) of the 6.VAT Directive,[146] or if it was a *direct, permanent and necessary extension* of a taxable activity (without being incidental to the main activity). The making available of capital to subsidiaries may of itself be considered an economic activity if it is not merely on an occasional basis and if it is "*not confined to managing an investment portfolio in the same way as a private investor and provided that it is carried out with a business or commercial purpose characterised by, in particular, a concern to maximise returns on capital investment*."[147] With respect to a possible extension of an economic activity, the Court made it clear that the making of loans to subsidiaries is not a direct, permanent and necessary extension of the supply of (management) services. "*Such loans are neither necessarily nor directly linked to services thus supplied*." [148] It is therefore clear from this case that dividends or interest payments will not become an economic activity, or part of an economic activity, just because of the fact that there is an existing economic activity of the (holding) company in the form of a supply of management services. Here we have, without any doubt, a direct or indirect involvement in the management of the subsidiary. But this does not *infect* the – parallel existing – non-economic activity of the (holding) company. The judgement of the Court in the *Floridienne and Berginvest* case was later on confirmed in the *Cibo Participations*

[142] Case C-142/99 (*Floridienne and Berginvest*), paragraph 6.
[143] Case C-142/99 (*Floridienne and Berginvest*), paragraphs 20 and 21; case C-288/94 (*Argos Distributors v Commissioners of Customs and Excise)*, ECR I-5311, paragraph 16; case 154/80 (*Staatssecretaris van Financien v Cooperatieve Aardappelenbewaarplaats)*, ECR 445, paragraph 12; see also case C-16/93 (*Tolsma*), ECR 1994, page I-743, paragraphs 13 and 14.
[144] Case C-142/99 (*Floridienne and Berginvest*), paragraphs 22 and 23.
[145] Case C-142/99 (*Floridienne and Berginvest*), paragraph 24.
[146] Now Article 9 (1) of the Council Directive 2006/112/EC.
[147] Case C-142/99 (*Floridienne and Berginvest*), paragraph 28.
[148] Case C-142/99 (*Floridienne and Berginvest*), paragraph 29.

case. In the *Cibo Participations* case the holding company supplied general, administrative, financial, commercial and technical management services on a flat rate basis of 0.5% of the turnover. Moreover, the chairman of the holding company became the chairman of the subsidiaries.[149] Even though it seems that there was a higher degree of direct or indirect involvement in the management of the subsidiaries than in the *Floridienne and Berginvest* case, the outcome cannot be different. The *Welthgrove* case is similar to the aforementioned two cases. However, there is one decisive difference: *Welthgrove* - an intermediate holding company - claimed to be involved in the management of the subsidiaries, but *without charging a remuneration* for such activities. The members of the board of directors of *Welthgrove* were engaged in the active guidance of its subsidiaries, but no additional staff was employed. However, *Welthgrove* received dividends from its subsidiaries.[150] In this case, the Court confirmed that the mere involvement of a holding company in the management of its subsidiaries without carrying out transactions subject to VAT cannot be regarded as an economic activity. [151]

4.2.1.2.2. Conclusions Regarding Economic Activity and Indirect Taxation

Some general principles can be derived from the existing VAT case law of the ECJ and the Council Directive 2006/112/EC:

1.) The second subparagraph of Article 9 (1) includes a typological enumeration of economic activities which is not concluding.

2.) The exploitation of tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity. The net result of the activity is not decisive.

3.) The exploitation of tangible or intangible property is, in principle, irrespective of the legal form. This underlines the very wide scope of value added tax.

4.) Economic activities of taxable persons are necessarily activities which are carried on with the object of obtaining payment of consideration or which are likely to be rewarded by the payment of consideration. This is true for both, the first and the second sentence of Article 9 (1) subparagraph 2 of the Council Directive 2006/112/EC, i.e. the supply of services and goods and the exploitation of tangible or intangible property.

5.) The nature of the (tangible or intangible) property can be an indicator for the question whether an economic activity will be pursued with the property in question.

6.) If it is planned to pursue an economic activity, even preparatory activities in an early stage will be attracted to the (future) economic activity.

7.) The mere acquisition and holding of shares and bonds does not amount to the exploitation of property for the purpose of obtaining income therefrom on a continuing

[149] Case C-16/00 *(Cibo Participations)*, paragraph 10.
[150] Case C-102/00 (*Welthgrove*), paragraph 5.
[151] Case C-102/00 *(Welthgrove)*, paragraph 17. See with respect to the question whether true and quasi factoring can be considered an economic activity: case C-305/01 (*Finanzamt Groß-Gerau v MKG-Kraftfahrzeuge-Factoring GmbH*), June 26, 2003, ECR 2003, page I-06729.

basis. The dividend and interest payment received is merely the result of the ownership of the property, but not a consideration for an economic activity.

8.) This is different if the holding is accompanied by *direct or indirect involvement in the management* of the companies.

9.) Direct or indirect involvement in the management of companies is limited to the supply of services for a consideration, i.e. only insofar can the activity be considered an economic activity. Non-economic activities will not become economic activities just because of the parallel existence of a supply of services of a (holding) company.

10.) The transactions in shares and bonds may fall within the scope of the VAT in cases (i) in which such transactions are effected as part of a commercial share-dealing or bond-dealing activity or (ii) in which they constitute the direct, permanent and necessary extension of an (existing) economic activity.

11.) The holding of shares and the granting of loans to subsidiary companies is not a direct, permanent and necessary extension of an economic activity such as the supply of management services of a holding company.

4.2.1.2.3. Economic Activity and Direct Taxation

The *Cadbury Schweppes* case could have been a perfect case for a clear separation between economic and non-economic activities, because such a separation might be of particular interest for the activities carried on by companies which are subject to CFC taxation. However, neither the ECJ nor the Advocate General Léger tried to find a clear definition. Instead, they took a different route which, however, is important and conclusive, too. In his Opinion to the case Advocate General Léger held that *"(...) 'establishment', within the meaning of Article 43 EC et seq., involves the actual pursuit of an economic activity in the host State. If the subsidiary is actually carrying on such an activity in that State and, in that connection, it provides genuine and actual services to the parent company, I do not think that that situation may be regarded, in itself, as tax evasion or avoidance, even if payment for those services leads to a reduction in the taxable profits of the parent company in the State of origin. Having regard to the objective of freedom of establishment, as long as the subsidiary carries on a genuine economic activity in the host State, there is no difference between the provision of services to third parties and the provision of those services to companies belonging to the same group as the subsidiary. In addition, the provision of services by a subsidiary to its parent company is an economic activity which takes the form of transactions between distinct legal persons. (...) Transactions between a CFC and its parent company which result in reducing the taxable profits of the latter can therefore be regarded as tax avoidance only if the establishment of that subsidiary and those transactions constitute (...) a wholly artificial arrangement aimed at circumventing national law.."*[152] The focus is on the separation between abusive (artificial) structures and "genuine economic activities" and the question of the actual type of services does not really play a role in the examinations. This becomes particularly obvious when the Advocate General outlines the three criteria which appear to be relevant for a distinction between a genuine economic activity in the

[152] Opinion of the Advocate General Léger (case C-196/04), paragraphs 106 to 108.

host Member State and a wholly artificial arrangement. In fact, these criteria were suggested by the United Kingdom and the Commission. The three criteria are

1.) the degree of physical presence of the subsidiary in the host State;

2.) the genuine nature of the activity provided by the subsidiary;

3.) the economic value of that activity with regard to the parent company and the entire group.[153]

According to Advocate General Léger, the first criterion requires that the subsidiary to be "*genuinely established in the host State*." This should be the case if the subsidiary has the premises, staff and equipment required to carry out the services provided.[154] The second criterion relates to the "*competence of the subsidiary's staff in relation to the services provided and the level of decision-making in carrying out those services*." If the subsidiary can be seen as "*a mere tool of execution,*" the structure may be considered wholly artificial.[155] Finally, the third criterion relates to the "*value added by the subsidiary's activity*." The latter should be of relevance if the services provided by the subsidiary have "*no economic substance in the light of the parent company's activity*."[156] Therefore, if the subsidiary company is genuinely established in the host state and carries out "useful" services with its own staff, the agreement cannot be considered wholly artificial - based on the Opinion of the Advocate General. The ECJ itself, however, did not explicitly pick up the "three criteria concept" of the Advocate General - suggested by the United Kingdom and the Commission - but concentrated on the first criterion. The ECJ outlined that *"(a)s suggested by the United Kingdom Government and the Commission at the hearing, that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment. If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a 'letterbox' or 'front' subsidiary.*"[157] The services provided in the *Cadbury Schweppes* case were related to the financing of group companies. However, I have no doubt that any other inter-company services, e.g. leasing, renting, licensing or similar services, in the same way have to be considered a genuine economic activity - in case of the fulfilment of the respective three criteria. I am referring to the three criteria - and not only to the criterion explicitly referred to by the ECJ - since it is not completely clear, in my opinion, whether the second and the third criterion also play a role in the examinations. I will come back to that aspect later on when this question is examined in some more detail.

[153] Opinion of the Advocate General Léger (case C-196/04), paragraph 111.
[154] Opinion of the Advocate General Léger (case C-196/04), paragraph 112.
[155] Opinion of the Advocate General Léger (case C-196/04), paragraph 113.
[156] Opinion of the Advocate General Léger (case C-196/04), paragraph 114.
[157] Case C-196/04 (*Cadbury Schweppes*), paragraphs 67, 68.

4.2.1.2.4. Conclusions Regarding Economic Activity and Direct Taxation

It is quite obvious from the case law of the ECJ that not each and every activity can be considered an economic activity. Even though a clear separation between economic activities and other activities may be difficult, it can be concluded that the holding of assets itself is not sufficient for a qualification as economic activity, but that additional elements are required. It seems to me that a certain "economic output" must be created in the host Member State. This can be, for example, the exercising of management functions related to subsidiary companies or the provision of additional services. Article 49 of the TFEU states that *"(...) restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State*." It is clear from the *Daily Mail* case that the right of establishment may also be exercised by opening an investment management office. This, at least, makes it clear that an investment management activity can be seen, in principle, as an economic activity in the sense of the right of establishment. It is also clear from the ECJ case law, in particular from the *Factortame* decision, that the subsidiary company which is established in another Member State may be "directed and controlled" from within the Member State of primary establishment. This makes it clear that a dependence on the decisions of the parent company is not, in general, contrary to the right of establishment. Thus, if a subsidiary company carries on its "own" activities without being a "mere tool of execution" of the parent company, such an activity will be in the scope of the right of establishment even if the activity is strongly influenced by the shareholders and even if the activity is only of limited overall importance - as long as the activity is not without any economic substance. Such minimum requirements are therefore equally important for activities which are usually considered - from the perspective of Member States - to be business activities (e.g. all kind of services provided to related or non-related parties) or investment management activities. In other words, an economic activity also encompasses investment management activities if the latter are not only limited to the holding of assets, shares et cetera, but also encompass their own income-producing activity which is carried out in the state of secondary establishment.

4.2.1.3. Fixed Establishment and the Freedom of Establishment

The economic activity must be pursued through a fixed establishment in another Member State.[158] Such a fixed establishment can be created by a migration from one Member State to another Member State (primary establishment) or by the setting-up of agencies, branches or subsidiaries (secondary establishment).[159] Since there is no direct link between the TFEU and double tax conventions, the terms "agency" and "branch" do not have to coincide with the term "permanent establishment" used in double tax conventions.[160] Of course, there is a certain likelihood that in many cases a permanent establishment in the sense of a double tax convention will also be considered to be an agency or branch in the context of Article 49 of the TFEU, but

[158] Case C-221/89 (*Factortame II*), paragraph 20.
[159] Article 49 and Article 54 of the TFEU.
[160] See in this respect also Kemmeren, Principle of Origin in Tax Conventions - A Rethinking of Models, pages 174, 175.

this will not necessarily always be the case. In the *Somafer* decision,[161] the ECJ stated that *"(t)he concept of branch, agency or other establishment implies a place of business which has the appearance of permanency, such as the extension of a parent body, has a management and is materially equipped to negotiate business with third parties so that the latter, although knowing that there will if necessary be a legal link with the parent body, the head office of which is abroad, do not have to deal directly with such parent body but may transact business at the place of business constituting the extension."* [162] Based on the statement of the Court, it can be concluded that three conditions have to be met in order to classify a place of business as a branch, agency or other establishment. The place of business:

1.) has the appearance of permanency;

2.) has a management; *and*

3.) is materially equipped to negotiate with third parties.[163]

The conditions "appearance of permanency" and (a certain degree of) "management" seem to be obvious, taking into consideration that the concept of establishment requires that an economic activity is pursued in another Member State for an indefinite period. The third condition, however, needs further explanations. I fully agree with the conclusion that an agency or branch has - to a certain extent - to be materially equipped, depending on the function and the extent of the agency or branch. What is not completely clear is the fact that the establishment should be equipped *to negotiate business with third parties*. If this is a requirement for the establishment in another Member State in the sense of Article 49 of the TFEU, it deviates in an important point from the concept of permanent establishment in the OECD-MTC. Pursuant to Article 5 (1) of the OECD-MTC the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.[164] This includes - similar to the conditions described above - a place of management.[165] A permanent establishment will not exist in cases in which only preparatory or auxiliary activities are carried on through the fixed place of business.[166] If a person acts on behalf of the enterprise and has, and habitually exercises, in a contracting state an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that state in respect of any activities which that person undertakes for the enterprise, unless the activities of such a person are limited to preparatory and auxiliary activities.[167] A permanent establishment does usually not exist if the activity is carried on through an independent agent, provided that such a person acts in the ordinary course of its business.[168] However, there is no requirement that the permanent establishment is *materially equipped to negotiate with third parties*. Moreover, there is not even a requirement that the permanent establishment has any

[161] Case 33/78 (*Somafer SA v Saar-Ferngas AG*), November 22, 1978, ECR 1978, page 02183.
[162] Case 33/78 (*Somafer*), paragraph 12.
[163] See with respect to the three conditions also Kemmeren, Principle of Origin in Tax Conventions - A Rethinking of Models, page 174
[164] Article 5 (1) of the OECD-MTC.
[165] Article 5 (2) (a) of the OECD-MTC. However, it is clear that a "place of management" is only one of several possibilities to constitute a permanent establishment.
[166] Article 5 (4) of the OECD-MTC.
[167] Article 5 (5) of the OECD-MTC.
[168] Article 5 (6) of the OECD-MTC.

relations to *third parties* at all. A permanent establishment can very well be constituted by the fulfilment of functions which are only directed to other group companies without having any other - third party - relationship.[169] In this respect one has to keep in mind that - under the TFEU - each company (e.g. within a group of companies) has an individual right of establishment.[170] One might even argue that - from an EU perspective - each single group company is to be seen (and treated) as a 'third party'. Therefore, I do not think that regarding *Somafer* the Court intended to stipulate a condition which refers directly to *third parties*. Even though the Court described the concept of branch, agency or other establishment in general terms, it must be seen - in my opinion - in the context of the underlying case. In the case itself, a French company created legal relations and obligations with third parties in Germany through its German branch. The third party relationship and the claims and obligations which can arise from the business of the branch office were therefore an important issue in the *Somafer* case. In my opinion, the Court certainly intended to stipulate a concept of branch, agency or other establishment, and in the context of the underlying case it makes perfect sense to do this in the way it was actually done by the Court. But the statement of the Court does not mean that a "third party element" was introduced as a condition for a place of business. In my opinion, it has to be understood in a different way: the place of business must be materially equipped to negotiate business with third parties *only if the negotiation with third parties is actually relevant*. If the establishment has to fulfil certain other functions which are only directed to the head office (or other related parties), it should be at least sufficiently equipped to carry out those functions. Of course, it is very likely that functions which are carried out - for example - by a subsidiary company or a permanent establishment towards other group companies require exactly the same equipment as the functions which are solely carried out towards unrelated parties. The third party element in relation to the equipment is, in my opinion, irrelevant and should therefore not be considered to be a condition for the place of business.

The aforementioned conclusion can also be drawn from the subsequent decisions in *Cadbury Schweppes* and *Columbus Container*, where the fact that services were provided towards related parties was not critical with respect to the question whether a 'fixed establishment' existed or not. In his Opinion to the *Cadbury Schweppes* case Advocate General Léger solely stated that *"(...) in this case it seems important to state that 'establishment' allows a Community national to participate, on a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom. Freedom of establishment thus concerns the genuine and actual pursuit of an economic activity in the host Member State. As stated by Advocate General Darmon in point 3 of his Opinion in the Daily Mail and General Trust case, 'establishment "means integration into a national economy"'. It is therefore the exercise of an economic activity in the host Member State which is the raison d'etre of freedom of establishment*."[171] However, the Advocate General made it clear that - in order to fulfil the first of the three criteria which were outlined earlier - the subsidiary company must be genuinely established in the host Member State.

[169] According to paragraph 26 of the Commentary to the OECD-MTC, a fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of Article 5 (4) (e) of the OECD-MTC, i.e. cannot be considered to be a preparatory or auxiliary activity.
[170] See in this respect Articles 49 and 54 of the TFEU.
[171] Advocate General Léger in his Opinion to case C-196/04 (*Cadbury Schweppes*), paragraph 42, with reference to the following cases: case C-2/74 (*Reyners*), paragraph 21, case C-55/94 (*Gebhard*), paragraph 25, case C-221/89 (*Factortame*), paragraph 20, and case C-246/89 (*Commission v United Kingdom*), paragraph 21.

This requires that the subsidiary company to have *"(...) the premises, staff and equipment necessary to carry out the services provided to the parent company*."[172] This was subsequently confirmed in the decision of the ECJ.[173] This is therefore a clear statement for an approach which merely focuses on the balance between the equipment (including premises, management and other personnel) and the actual functions exercised by the subsidiary company - no matter whether the services are provided to related or unrelated parties.

4.2.2. Conclusions Regarding the Freedom of Establishment

The concept of establishment was described by the ECJ as the "*actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period*." This should enable the EU national "*to participate, on a stable and continuous basis, in the economic life of a Member State other than his State of origin and to profit therefrom*." The latter has to be seen, in my opinion, in contrast to the freedom to provide services, which only lead to a temporary link to the other Member State. The freedom of establishment is, thus, a far-reaching concept which provides the possibility for EU nationals to carry on an economic activity in another Member State and to profit from a full integration in the latter Member State. The previously described case law of the ECJ shows, in my opinion, that it is not too difficult to come into the scope of the freedom of establishment. In the context of this study, where the focus is on outbound investments in other Member States through subsidiary companies, it seems to me that the following requirements established in the case law of the ECJ are of particular importance and may need additional clarification:

(i) the actual pursuing of an economic activity;

(ii) through a fixed establishment in another Member State; and

(iii) the definite influence over the company's decisions.

With respect to the requirement of pursuing an economic activity, it seems to be obvious that not each and every activity can be considered to be an economic activity. In my opinion, there must be a certain "economic output" which is created in the host Member State. The mere holding of assets or shares can therefore not be seen as the pursuing of an economic activity in the host Member State. The assets may be seen as an "instrument" which may be utilised for an economic activity. It is therefore obvious that capital intensive services - like leasing, renting, or licensing activities - are economic activities. In the latter case, it should, based on the *Cadbury Schweppes* decision, neither play a role whether the activities are carried on with related or unrelated parties nor whether the services are of minor importance in the overall context, e.g. within a group of companies. Even the fact that the activities are "directed and controlled" from within the Member State of primary establishment should, based on the *Factortame* decision, not be an element which may be contrary to the right of establishment. It is required, however, that the subsidiary company carries out its "own" activities in the host Member State and that the subsidiary company is not just a "mere tool of execution" of the parent company. Similar aspects should apply for holding companies: the mere holding of shares cannot be seen as

[172] Advocate General Léger in his Opinion to case C-196/04 (*Cadbury Schweppes*), paragraph 112.
[173] Case C-196/04 (*Cadbury Schweppes*), paragraph 67.

an economic activity. Here, it might be sufficient, in my opinion, that additional services are provided towards the subsidiary companies which can be, for example, the providing of financial means by way of cash pooling et cetera. The mere combination of a holding of shares and a holding of bonds or loan amounts, however, may not be sufficient since it is just the combination of holding different assets - without carrying on additional activities. Moreover, there is no necessity to differentiate - in a narrower sense - between "business activities" and "investment management activities." Such a differentiation is, in my opinion, not required for the question of being in the scope of Article 49 of the TFEU or not. The approach is not only supported by the *Cadbury Schweppes* decision but also by the *Daily Mail* decision.

The economic activity described above must be pursued in the host Member State through a fixed establishment for an indefinite period. In effect, any economic activity which is not only temporarily carried on in the Member State of secondary establishment requires some sort of fixed place of business and therefore physical presence - even if it is just an activity of minor importance. Based on the *Somafer* decision it can be concluded that the place of business requires (i) the appearance of permanency, (ii) a management and (iii) must be materially equipped for the carrying out of the respective functions. In other words, the establishment must be sufficiently equipped (premises, management, staff, equipment et cetera) in order to provide the respective services or any other function by its own and without being a "mere tool of execution" of - for example - the parent company. Again, this does not require that the subsidiary company acts totally independent and without any direction and controlling from the shareholder, but it requires that the (perhaps minor) functions are actually and physically carried on by the subsidiary company itself at a fixed place of business within the host Member State.

Another aspect of great importance is the fact that the shareholder - in order to come into the scope of the freedom of establishment - must have a *"(...) definite influence over the company's decisions and allows him to determine its activities*." It is still not completely clear from case law of the ECJ whether the requirement of a "definite influence" can be linked to a certain percentage of shareholding (or voting rights) and how the collaboration of shareholders has to be seen in this context. In the *ICI* case, the company which invoked the right of establishment had a shareholding of 49 percent in the intermediate holding company and in the *Überseering* case there were two shareholders who held *together* 100 percent in the respective company. In the *SGI* case a shareholding of 34 percent was sufficient to come within the scope of the freedom of establishment. In the *Columbus Container* case, the shares in a Belgian limited partnership were held, on the one hand, by eight members of the same family, each member having 10 percent holding, and, on the other hand, as regards the remaining 20 percent, by a German partnership. The shares in the German partnership were, in turn, also held by members of that family. The family members took decisions concerning the Belgian partnership by agreement through the same representative at the general meeting of the partnership. In this case, the ECJ concluded that the freedom of establishment was affected. That means that even a shareholding of 10 to 12.50 percent can be sufficient to come within the scope of Article 49 of the TFEU if there are further elements which show that the shareholders are acting together and, therefore, the shareholding confers definite influence over the company's decisions.

4.2.3. The Freedom to Provide Services

Pursuant to Article 56 of the TFEU restrictions on the freedom to provide services within the Union shall be prohibited regarding nationals of Member States who are established in a State of the Union other than that of the person for whom the services are intended.[174] Services shall be considered to be "services" within the meaning of the Treaties where they are normally provided for remuneration, in so far as they are not governed by the provisions relating to freedom of movement for goods, capital and persons.[175] This shall particularly include the activities of an industrial and commercial character, as well as activities of craftsmen and professions.[176] Without prejudice to the provisions of the Chapter relating to the right of establishment, the person providing a service may, in order to do so, temporarily pursue its activity in the State in which the service is provided, under the same conditions as are imposed by that State on its own nationals.[177]

4.2.3.1. Case Law of the European Court of Justice

4.2.3.1.1. The *Gebhard* Case

In the *Gebhard case* the ECJ outlined that "(*t)he situation of a Community national who moves to another Member State of the Community in order there to pursue an economic activity is governed by the chapter of the Treaty on the free movement of workers, or the chapter on the right of establishment or the chapter on services, these being mutually exclusive."* [178] The pursuing of an economic activity is therefore equally relevant for the freedom to provide services and the freedom of establishment. However, the ECJ stated that *"(t)he provisions of the chapter on services are subordinate to those of the chapter on the right of establishment in so far, first, as the wording of the first paragraph of Article 59 assumes that the provider and the recipient of the services concerned are "established" in two different Member States and, second, as the first paragraph of Article 60 specifies that the provisions relating to services apply only if those relating to the right of establishment do not apply."* [179] The decisive element is that the provider of services in the sense of chapter 3 pursues his activity in the other Member State on a temporary basis. Pursuant to the Court, "(…) *the temporary nature of the activities in question has to be determined in the light, not only of the duration of the provision of the service, but also of its regularity, periodicity or continuity. The fact that the provision of services is temporary does not mean that the provider of services with the meaning of the Treaty may not equip himself with some form of infrastructure in the host Member State (including an office, chambers or consulting rooms) in so far as such infrastructure is necessary for the purpose of performing the services in question."* [180]

[174] Article 56 (1) of the TFEU.
[175] Article 57 (1) of the TFEU.
[176] Article 57 (2) of the TFEU.
[177] Article 57 (3) of the TFEU.
[178] Case C-55/94 (*Gebhard*), paragraph 20.
[179] Case C-55/94 (*Gebhard*), paragraph 22.
[180] Case C-55/94 (*Gebhard*), paragraph 27.

4.2.3.1.2. The *Eurowings* Case

Typical services which can be rendered from a provider in one Member State to a recipient in another Member State on a permanent basis which do not necessarily require any infrastructure in the Member State of the recipient are leasing services. In the *Eurowings* case,[181] the ECJ had to decide on the German treatment of leasing payments which will be outlined in more detail below. *Eurowings Luftverkehrs AG*, an operator of scheduled and charter flights in Germany and Europe, leased an aircraft form Air Tara Ltd. in Ireland.[182] There was no doubt for the Court that leasing services were services within the meaning of Article 57 of the TFEU and that they were therefore within the scope of the freedom to provide services.[183] The leasing of an aircraft is typically a long-term agreement, i.e. the services are rendered over a certain period of time to a recipient in another Member State. Taking into account that such a provider of leasing services is typically the lessor of not only one aircraft, and that the intention is to renew the leasing agreements, it can be assumed that these kinds of services are rendered on a permanent and continuous basis without any involvement in the territory of another Member State or with a very limited - temporary - activity in the Member State of the recipient. The fact that leasing agreements are within the scope of the freedom to provide services is not surprising, but these kinds of services, or at least services which contain similar elements compared to leasing agreements, are typical services which are of particular importance in the context of this study. In its decision, the Court held that the leasing activities come within the scope of the freedom to provide services and that the recipient of the leasing services may rely on the latter basic freedom.[184]

4.2.4. Conclusions Regarding the Freedom to Provide Services

The basic difference between the freedom of establishment and the freedom to provide services is therefore that the first one requires the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period of time, i.e. on a stable and continuous basis, whereas the latter requires the actual pursuit of an economic activity from either within the Member State of primary establishment towards the recipient in another Member State or with a temporary link to the Member State of the recipient of the services. Apparently, the freedom of establishment and the freedom to provide services both require the actual pursuit of an economic activity. Hence, there is a certain overlapping of the requirements to come within the scope of the latter two freedoms. Nonetheless, it is unlikely - at least for investments in the context of this study - that two activities will be covered simultaneously by the freedom of establishment and the freedom to provide services. This, however, will be examined later on in more detail.

[181] Case C-294/97 (*Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna*), October 26, 1999, ECR 1999 page I-07447; see with respect to the *Eurowings* case also Thömmes, Das EuGH-Urteil in der Rechtssache Eurowings - nun ist der Gesetzgeber gefordert, Internationales Steuerrecht 1999, page 753; Thömmes / Kowallik, ECJ Decided on German Taxation of Leasing, Tax Notes International 2000, page 865 et seq.; Bullinger, Inländerdiskriminierung im Steuerrecht am Beispiel des Par. 8 Nr. 7 GewStG, Internationales Steuerrecht 2005, page 370 et seq.

[182] Case C-294/97 (*Eurowings*), paragraph 13.

[183] Case C-294/97 (*Eurowings*), paragraph 33.

[184] Case C-294/97 (*Eurowings*), paragraph 34; cases 286/82 and 26/83 (*Luisi and Carbone*), paragraph 16.

4.2.5. The Free Movement of Capital

Pursuant to Article 63 of the TFEU, all restrictions on the movement of capital and payments between Member States and between Member States and third countries shall be prohibited.[185] Article 64 (1) of the TFEU includes a 'standstill clause' and Article 65 of the TFEU provides, *inter alia*, for further clarification and concessions to the Member States. This shall be outlined in the context of the justifications. From the *Daily Mail* case it is clear that a Member State is prohibited to hinder the establishment of its own nationals or companies in another Member State.[186] The Court ruled in this case - with respect to the freedom of establishment - that "(*e)ven though those provisions are directed mainly to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in Article 58. As the Commission rightly observed, the rights guaranteed by Articles 52 et seq. would be rendered meaningless if the Member State of origin could prohibit undertakings from leaving in order to establish themselves in another Member State*."[187] This was later on repeated by the Court in several other cases which dealt with the freedom of establishment.[188] The question came up whether the statement of the Court in these cases could be transferred to the free movement of capital. In the context of Article 63 of the TFEU the rights conferred by the free movement of capital would be rendered meaningless if a Member State could prohibit the investment of one of its nationals or of a company incorporated under its legislation in another Member State (or third countries).[189] With the *Verkooijen* decision [190] it became clear that the principle determined in the context of the freedom of establishment was equally applicable to the free movement of capital. I will come back to the *Verkooijen* decision below.

The differentiation between the free movement of capital and the free movement of payments is outlined in the *Luisi and Carbone* case,[191] where the ECJ stated that *"(...) current payments are transfers of foreign exchange which constitute the consideration within the context of an underlying transaction, whilst movements of capital are financial operations essentially concerned with the investment of the funds in question rather than remuneration for a service. For that reason movements of capital may themselves give rise to current payments (...)*" [192] and *"(t)he physical transfer of bank notes may not therefore be classified as a movement of capital where the transfer in question corresponds to an obligation to pay arising from a transaction involving the movement of goods or services."* [193] The movement of capital may be understood as an unilateral and one-sided transfer of capital from one

[185] Article 63 (1) of the TFEU (capital) and Article 63 (2) (ex Article 73 b (2)) of the TFEU (payments).
[186] Case 81/87 (*The Queen v. H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust PLC*), September 27, 1988, ECR 1988 page 5483.
[187] Case 81/87 (*Daily Mail*), paragraph 16.
[188] Case C-264/96 (*ICI*), paragraph 21; case C-200/98 (*X and Y*), paragraph 26; case C-251/98 (*Baars*), paragraph 28.
[189] See also Sandler, Tax Treaties and Controlled Foreign Company Legislation, page 186.
[190] Case C-35/98 (*Staatssecretaris van Financien v B.G.M. Verkooijen*), June 6, 2000, ECR 2000, page I-04071.
[191] Cases 286/82 and 26/83 (*Graziana Luisi and Giuseppe Carbone v Ministero del Tesoro*), January 31, 1984, ECR 1984 page 00377.
[192] Cases C 286/82 and 26/83 (*Luisi and Carbone*), paragraph 21.
[193] Cases C 286/82 and 26/83 (*Luisi and Carbone*), paragraph 22.

Member State to another Member State, which may at the same time typically be seen as an investment.[194] The transfer is not made for the purpose of discharging an obligation in exchange for services rendered or goods supplied.[195] For the purpose of this study, the movement of capital is of particular relevance. I will therefore concentrate the following verifications on the movement of capital and I will not go into detail regarding the movement of payments.

With respect to the scope of the free movement of capital the ECJ stated in the *Trummer and Mayer* case [196] that the meaning of the term "movement of capital" should be determined by reference to the nomenclature in Annex I to Council Directive 88/361/EEC.[197] The reason is that the TFEU itself does not contain any definition of the term "movement of capital."[198] However, the nomenclature is not an exhaustive list for the notion of capital movements and it should therefore not be interpreted as restricting the scope of the principle of the full liberalisation of capital movements as referred to in Article 1 of the Directive.[199] The capital movements are classified according to the economic nature of the assets and liabilities they concern, and it is structured as follows:

1.) direct investments
- establishment and extension of branches or new undertakings belonging solely to the person providing the capital, and the acquisition in full of existing undertakings
- participation in new or existing undertaking with a view to establishing or maintaining lasting economic links
- long term loans with a view of establishing or maintaining lasting economic links
- reinvestment of profits with a view to maintaining lasting economic links

2.) investments in real estate
3.) operations in securities normally dealt in on the capital markets
- shares and other securities of a participating nature
- bonds

4.) operations in units of collective investment undertakings
5.) operations in securities and other instruments normally dealt in on the money market
6.) operations in current and deposit accounts with financial institutions
7.) credits related to commercial transactions or to the provision of services in which a resident is participating
- short-, medium-, and long-term

8.) financial loans and credits
- short-, medium-, and long-term

9.) sureties, other guarantees and rights of pledge
10.) transfer in performance of insurance contracts

[194] Kiemel in Groeben, Kommentar zum EU/EG Vertrag, Article 56, paragraph 1.
[195] See also Sedlaczek, Capital and Payments: The Prohibition of Discrimination and Restrictions, European Taxation 2000, page 14 et seq. (17).
[196] Case C-222/97 (*Manfred Trummer and Peter Mayer*), March 16, 1999, ECR 1999 page I-01661.
[197] Council Directive 88/361/EEC, June 24, 1988; see also Sedlaczek, Capital and Payments: The Prohibition of Discrimination and Restrictions, European Taxation 2000, page 14 et seq. (16).
[198] Case C-222/97 (*Trummer and Mayer*), paragraphs 7 and 20; see in ths respect also the joined cases C-163/94, C-165/94 and C-250/94 *(Criminal proceedings against Lucas Emilio Sanz de Lera, Raimundo Diaz Jimenez and Figen Kapanoglu*), December 14, 1995, ECR 1995, page I-04821, paragraph 34.
[199] Case C-222/97 (*Trummer and Mayer*), paragraphs 13, 21; see also the joined cases C-515/99, C-519/99 to 524/99, and C-526/99 to C-540/99 (*Reisch and Others*), paragraph 30; case C-513/03 (*van Hilten*), paragraph 39; Annex I of the Council Directive 88/361/EEC.

11.) personal capital movements
12.) physical import and export of financial assets
13.) other capital movements

According to the explanatory notes of the nomenclature, direct investments have the meaning of investments of all kinds by natural persons or commercial, industrial or financial undertakings, and which serve to establish or to maintain lasting and direct links between the person providing the capital and the entrepreneur or the undertaking to which the capital is made available in order to carry on an economic activity. This concept must therefore be understood in its widest sense.[200] The undertakings mentioned under no. 1 (first insertion) include wholly owned subsidiaries and branches. The undertakings referred to under no. 1 (second insertion) which have the status "limited by shares" and there is participation in the nature of direct investment where the block of shares held by a natural person of another undertaking or any other holder enables the shareholder, either pursuant to the provisions of national laws relating to companies limited by shares or otherwise, to effectively participate in the management of the company or in its control.[201] The direct investments described under no. 1 (first and second insertion) may coincide to a large extent with the investments covered by the freedom of establishment. The direct investment in this sense requires - in the same way as the freedom of establishment does - that the capital is made available in order to carry on an *economic activity.* Up to this point, there is a certain overlapping with Article 49 of the TFEU. This was basically confirmed in the jurisprudence of the ECJ. In the *Orange European Smallcap Fund* case, [202] the question was raised whether "direct investment" in Article 64 (1) of the TFEU also includes the holding of a block of shares in a company if the holder of the shares holds them only as an investment and the size of the block does not confer a decisive influence over the management or control of the company.[203] In its decision the Court stated, in essence, that "direct investment" presupposes that the shareholding in the new or existing undertakings enables the shareholder, either pursuant to the provisions of national law relating to companies limited by shares or in some other way, to participate effectively in the management of that company or in its control.[204]

However, the free movement of capital goes much further than the freedom of establishment. Long-term loans of a participating nature are also considered to be direct investments. Pursuant to the explanatory notes, this is the case if loans are granted for a period of more than five years and which are granted for the purpose of establishing or maintaining lasting economic links.[205] The explanatory notes outline

[200] Directive 88/361/EEC, Annex I, Explanatory Notes (Direct Investments).
[201] Directive 88/361/EEC, Annex I, Explanatory Notes (Direct Investments).
[202] Case C-194/06 (*Staatssecretaris van Financien v Orange European Smallcap Fund NV*), May 20, 2008. See with respect to the *Orange European Smallcap Fund* decision also Weber, ECJ concludes Netherlands Fiscal Investment Fund Regime incompatible with EC Law: *Orange European Smallcap Fund*, Tax Planning International European Tax Service, June 2008.
[203] Case C-194/06 (*Orange European Smallcap Fund*), paragraph 20.
[204] Case C-194/06 (*Orange European Smallcap Fund*), paragraphs 101, 102. See with respect to the previous attempts to quantify the concept of direct investment: Smit, Capital Movements and Third Countries: The Significance of the Standstill-Clause ex-Article 57 (1) of the EC Treaty in the Field of Direct Taxation, EC Tax Review 2006, page 203 et seq. (206); Sedlaczek, Capital and Payments: The Prohibition of Discrimination and Restrictions, European Taxation 2001, page 17; Schönfeld, Die Fortbestandsgarantie des Art. 57 Abs. 1 EG im Steuerrecht: Anmerkung zu FG Hamburg vom 9.3.2004, VI 279/01, EFG, 2004, 1573, Internationales Steuerrecht 2005, page 412.
[205] Directive 88/361/EEC, Annex I, Explanatory Notes (Direct Investments).

that this includes especially loans granted by a company to its subsidiaries or to companies in which it has a share and loans linked with a profit-sharing arrangement.[206] Apart from the direct investments, the investment in land, buildings, portfolio investments in shares and bonds, financial loans, credits, and a large number of other capital movements are included in the nomenclature and are therefore within the scope of the free movement of capital. At first glance it seems that the participation in a company which does not fulfil the requirements of a direct investment (part I) - e.g. a small percentage of shareholding without any influence - and which is not listed on a stock exchange or another capital market is not explicitly mentioned in the nomenclature. The investment in companies referred to in part III comprises securities which are normally dealt on a capital market. However, when considering the (non-exhaustive) financial transfers and transactions referred to in the nomenclature, it is quite obvious that the transfer of financial means[207] from one Member State to another state in order to invest in a participation - even if it is without any influence on the business of the respective company - is within the scope of the free movement of capital. The investments are not restricted whatsoever to a certain minimum amount or percentage. Moreover, the investments described in the nomenclature and the explanatory notes are not linked to an economic activity, apart from the explanation of direct investments. The fact that direct investments require that the "*capital is made available in order to carry on an economic activity*" [208] does not mean that economic activity is of any relevance for the other capital movements covered by the nomenclature, which are indirect investments. This was basically confirmed by the ECJ in a number of cases, not only with respect to the investment in shares[209] but also with respect to the investment in immovable property.[210]

4.2.5.1 Case Law of the European Court of Justice

4.2.5.1.1. The *Verkooijen* Case

In *Verkooijen*[211] the Court had to decide on a different treatment of dividends received from companies established in another Member State compared to dividends received from domestic companies. Similar to the *Trummer and Mayer* case the Court referred to Directive 88/361 and made it clear that the Treaty does not define the term "capital movements." The Court examined whether the receipt of dividends falls within the scope of the free movement of capital and concluded that this is the case, although the receipt of dividends is not expressly mentioned in the nomenclature annexed to the Directive.[212]

---

[206] Directive 88/361/EEC, Annex I, Explanatory Notes (Direct Investments).
[207] The same is true for the transfer of assets.
[208] Directive 88/361/EEC, Annex I, Explanatory Notes (Direct Investments).
[209] See, for example, case C-35/98 (*Verkooijen*), case C-315/02 (*Lenz*), case C-319/02 (*Manninen*), case C-292/04 (*Meilicke*).
[210] Case C-364/01 (*Barbier*), paragraph 58.
[211] Case C-35/98 (*Verkooijen*), dated June 6, 2000. See with respect to the *Verkooijen* decision also Stangl, Der Begriff der steuerlichen Kohärenz nach den Urteilen Baars und Verkooijen, Steuer und Wirtschaft International 2000, page 463 et seq.; Lupo, Reliefs from Economic Double Taxation on EU Dividends: Impact of the Baars and Verkooijen Cases, European Taxation 2000, page 270 et seq.; Wimpissinger, Der Fall Verkooijen und seine Auswirkungen, Steuer und Wirtschaft International 2000, page 313 et seq.; Boekhorst, Dutch Dividend Relief in Breach of E.U. Law, Tax Planning International European Union Focus 2000, page 21 et seq.
[212] Case C-35/98 (*Verkooijen*), paragraph 28.

The Court stated that *"(a) legislative provision such as the one at issue in the main proceedings has the effect of dissuading nationals of a Member State residing in the Netherlands from investing their capital in companies which have their seat in another Member State*"[213] and *"(s)uch a provision also has a restrictive effect as regards companies established in other Member States: it constitutes an obstacle to the raising of capital in the Netherlands since the dividends which such companies pay to Netherlands residents receive less favourable tax treatment than dividends distributed by a company established in the Netherlands, so that their shares are less attractive to investors residing in the Netherlands than shares in companies which have their seat in that Member State*." [214] The restriction is twofold and coincides with the rulings of the Court with respect to the freedom of establishment in *Daily Mail* [215] and *Baars*.[216] It is not limited to the "capital export" of a resident of a Member State to another Member State, and therefore directed from the investor towards its own Member State, but also comprises the "capital import" into another Member State, i.e. if it is directed from the company which attracts the investments towards the other Member State where the capital flow comes from.

[213] Case C-35/98 (*Verkooijen*), paragraph 34.
[214] Case C-35/98 (*Verkooijen*), paragraph 35.
[215] Case 81/87 (*Daily Mail*), paragraph 16.
[216] Case C-251/98 (*Baars*), paragraph 29.

4.2.5.1.2. The Cases *Lenz, Manninen* and *Meilicke*

The *Lenz* case[217] and the *Manninen* case [218] are a consistent continuation of the *Verkooijen* jurisprudence - at least with respect to the scope of the free movement of capital. The same is true for the *Meilicke* case.[219] The *Lenz* case deals with a

[217] Case C-315/02 (*Anneliese Lenz v Finanzlandesdirektion für Tirol*), July 15, 2004. See with respect to the *Lenz* case also Schuch, Pending Cases Filed by Austrian Courts: The Lenz Case, in Direct Taxation: Recent ECJ Developments, 2003, page 137 et seq.; Daiber / Offermanns, Gleichbehandlung von Kapitalerträgen aus Quellen innerhalb der Europäischen Union für steuerliche Zwecke, Internationale Wirtschafts-Briefe 2004, Fach 11A, page 795 et seq.; Aigner / Kofler, Austria Clarifies Third-Country Impact of ECJ's Lenz Decision, Tax Notes International 2004, page 477 et seq.; Englisch, Fiscal Cohesion in the Taxation of Cross-Border Dividends, European Taxation 2004, page 323 et seq. (Part One) and page 355 et seq. (Part Two); Eicker / Obser, Die Kapitalverkehrsfreiheit bekommt Konturen: zugleich Anmerkungen zu den Schlussanträgen in den Rechtssachen Weidert und Paulus, Manninen und Lenz, Internationales Steuerrecht 2004, page 443 et seq.; Polivanova-Rosenauer / Toifl, Besteuerung ausländischer Kapitalerträge und jüngste Rechtsprechung des EuGH, Steuer und Wirtschaft International 2004, page 228 et seq.

[218] Case C-319/02 (*Petri Manninen*), September 7, 2004. See with respect to the *Manninen* case also Schnitger, Grenzüberschreitende Körperschaftsteueranrechnung und Neuausrichtung der Kohärenz nach dem EuGH-Urteil in der Rs. Manninen, Finanz-Rundschau 2004, page 1357 et seq.; Medert, Anmerkungen zur Körperschaftsteuer-Gutschrift nach dem EuGH-Urteil C-319/02 vom 7.9.2004 (Manninen), Internationales Steuerrecht 2004, page 828 et seq.; Balster / Petereit, Anrechnung ausländischer Steuern nach dem EuGH-Urteil in der Rechtssache "Manninen" trotz Bestandskraft!, Deutsches Steuerrecht 2004, page 1985 et seq.; Gosch, Anrechnung ausländischer Steuern nach dem EuGH-Urteil in der Rechtssache "Manninen" trotz Bestandskraft?, Deutsches Steuerrecht 2004, page 1988 et seq.; Weerth, Grenzüberschreitende Körperschaftsteueranrechnung nach "Manninen"!, Deutsches Steuerrecht 2004, page 1992 et seq.; Hamacher / Hahne, Aspekte der Anrechnung von Körperschaftsteuern auf ausländische Dividendenerträge: Auswirkungen des EuGH-Urteils vom 7.9.2004 Rs. C-319/02, Manninen, Der Betrieb 2004, page 2386 et seq.; Eicker / Ketteler, Die verfahrensrechtliche Durchsetzung von Gemeinschaftsrecht im Steuerrecht am Beispiel der Rs. Manninen und die Frage der Durchbrechung der Bestandskraft, Betriebs-Berater 2005, page 131 et seq.; Lindemann, Auswirkungen der EuGH-Verfahren Manninen/Meilicke für die Investmentbesteuerung, Betriebs-Berater 2005, page 1931 et seq.; Weerth, Zur rückwirkenden Anwendung von EuGH-Urteilen am Beispiel der "Manninen"-Entscheidung des EuGH, Der Betrieb 2005, page 1407 et seq.; Meilicke / Sedemund, Welche Steuern sind nach dem Manninen-Urteil des EuGH in Deutschland anzurechnen?, Der Betrieb 2005, page 2040 et seq.; Hahn, Par. 175 Abs. 2 AO n. F. und das EuGH-Urteil in der Rechtssache Manninen: ein Lehrstück darüber, wie man es nicht macht, Internationales Steuerrecht 2005, page 145 et seq.; Engel / Hammerschmidt, Die Bedeutung der Rechtssache Manninen für die deutsche Besteuerungspraxis, Internationales Steuerrecht 2005, page 405 et seq.; Wagner, Die Zukunft des internationalen Steuerrechts nach dem Manninen-Urteil, Deutsche Steuer-Zeitung 2005, page 325 et seq.; Hintsanen /Pettersson, The Implications of the ECJ Holding the Denial of Finnish Imputation Credits in Cross-Border Situations to be Incompatible With the EC Treaty in the Manninen Case, European Taxation 2005, page 130 et seq.; Intemann, Das Körperschaftsteueranrechnungsverfahren auf dem Prüfstand des EuGH: Anrechnung ausländischer Körperschaftsteuer nach der Manninen-Entscheidung, Neue Wirtschafts-Briefe 2005, page 4955 et seq.; O'Shea, Dividend Taxation Post-Manninen: Shifting Sands or Solid Foundations?, Tax Notes International 2007, page 887 et seq.

[219] Case C-292/04 (*Wienand Meilicke, Heidi Christa Weyde, Marina Stöffler v. Finanzamt Bonn-Innenstadt*), March 6,2007. See with respect to the *Meilicke* case also Stok / Thomson, Temporal Limitations to Tax Judgements of the European Court of Justice, Intertax 2006, page 552 et seq.; Seer, The Jurisprudence of the European Court of Justice: Limitation of the Legal Consequences?, European Taxation 2006, page 470 et seq.; Cloer, Ausschluss der Steuergutschrift für Dividenden von Aktiengesellschaften mit Sitz in anderem Mitgliedstaat - Verstoss gegen Kapitalverkehrsfreiheit? Begrenzung der zeitlichen Wirkung des Urteils? - Schlussanträge Rs. Meilicke, in Europäisches Wirtschafts- und Steuerrecht 2006, pages 36, 37; Lüdicke, Pending Cases Filed by German Courts I: The Meilicke Case, in: ECJ - Recent Developments in Direct Taxation, 2006, page 115 et seq.; Balmes / Ribbrock, Die Schlussanträge in der Rechtssache Meilicke: Vorschlag einer zeitlichen Begrenzung der Wirkung des Urteils „auf Zuruf" der Mitgliedstaaten?!, Betriebs-Berater 2006, page 17 et seq.; Lang, Die Beschränkung der zeitlichen Wirkung von EuGH-Urteilen im Lichte des Urteils Meilicke, Internationales Steuerrecht 2007, page 235 et seq.; Sedemund, Voraussetzungen für die Körperschaftsteueranrechnung nach dem EuGH-Urteil Meilicke, Internationales Steuerrecht 2007, page 245 et seq.; Delbrück / Hamacher, Meilicke und die Rückwirkung - Zu Par. 130 AO bei der praktischen Umsetzung des EuGH-Urteils Meilicke, Internationales Steuerrecht 2007, page 627 et seq.; Lüdicke, Pending Cases Filed by German Courts: The *Meilicke, Burda, Gronfeldt, Jäger, Heinrich Bauer Verlag, Rewe Zentralfinanz, Lidl*

provision in the Austrian income tax law which provides for a different treatment of dividends received from domestic companies and dividends received from foreign companies (in this case dividends from a Germany company). The foreign dividends paid to an Austrian taxpayer are subject to ordinary income tax which can amount to - depending on the total taxable income of the Austrian taxpayer - up to 50 percent. In contrast thereto, dividends received from domestic companies are subject to a different treatment: the taxpayer may opt for a definite taxation (flat tax) of 25 percent or, as an alternative, may choose the taxation according to the half rate system. In the latter case, the tax rate is reduced to half of the average tax rate applicable to the aggregate taxable income.[220]

In the *Manninen* case, the ECJ had to deal with the Finnish tax credit system which provided - similar to the *Lenz* case - for a different treatment of dividends received from domestic sources and dividends received from foreign sources.[221] Pursuant to the Finnish system, the corporate income tax levied on the taxable profit of the Finnish company is creditable against the income tax levied on the dividend income of the shareholder. Since the corporate income tax rate and the income tax levied on the dividend income are both 29 percent, the system provides for an avoidance of double taxation. However, no tax credit is provided for dividends received from foreign companies. Thus, a double taxation may only be avoided in case of domestic investments but not in case of foreign investments. The *Meilicke* case is very similar to the *Manninen* case and dealt with the German imputation system.

In the same way as outlined above in the *Verkooijen* decision the ECJ did not make any differentiation between direct investments and portfolio investments but in all three cases concluded that *"(...) legislation such as that at issue in the main proceedings constitutes a restriction on the free movement of capital"*.[222] The ECJ did not deal with the question of the underlying percentage of shareholding in the foreign companies nor with the activity of those companies. It seems to be quite obvious that this does not play any role for the question whether Article 63 of the TFEU is applicable or not.[223] The portfolio investments in the publicly listed companies are - based on the existing case law - definitely within the scope of the free movement of capital. In addition, it is worth mentioning that in the *Lenz* case, the *Manninen* case and the *Meilicke* case the ECJ stipulated again that the respective domestic provisions not only have the effect of deterring fully taxable persons in Austria (respectively Finland and Germany) from investing their capital in companies established in other Member States but do also have a restrictive effect as regards companies established in other Member States, in that they constitute an obstacle to their raising capital in Austria (respectively Finland and Germany).[224]

Belgium, Stahlwerk Ergste Westig and Deutsche Shell Cases, in ECJ - Recent Developments in Direct Taxation, 2007, page 47 et seq.; Thömmes, Verpflichtung zur Anrechnung ausländischer Körperschaftsteuer - keine zeitliche Beschränkung der Urteilswirkungen, Internationale Wirtschafts-Briefe 2007, Fach 11A, page 1131 et seq.

220 See with respect to the Austrian legal background paragraphs 3-10.

221 Case C-319/02 (*Manninen*), paragraph 12.

222 Case C-319/02 (*Manninen*), paragraph 24, case C-315/02 (*Lenz*), paragraph 22, case C-292/04 (*Meilicke*), paragraph 20.

223 See in this respect also C-516/99 (*Walter Schmid*), May 30, 2002, ECR 2002, page I-04573. Mr. Schmid held a portfolio investment in the publicly listed German MAN AG.

224 Case C-319/02 (*Manninen*), paragraphs 22, 23; case C-315/02 (*Lenz*), paragraphs 20, 21; case C-292/04 (*Meilicke*), paragraphs 23, 24.

4.2.6. Conclusions Regarding the Free Movement of Capital

Without any doubt, the scope of the free movement of capital is much broader than the scope of the freedom of establishment (and basically also the freedom to provide services) and also encompasses portfolio investments. This is, of course, of utmost importance in the context of this study. The actual pursuit of an economic activity is not, in principle, one of the requirements to come within the scope of Article 63 of the TFEU. Therefore, the free movement of capital covers a broad range of foreign investments which are not covered by the freedom of establishment. This is particularly relevant for shareholdings which do not provide a definite influence over the company's decisions - due to the fact that the investor only holds a small and insignificant percentage in the respective company. Moreover, the scope of the free movement of capital is not limited to investments in other Member States but Article 63 of the TFEU is equally relevant for investments in non-member states. However, the decisive question is the relationship between the freedom of establishment, the free movement of capital and the freedom to provide services in the light of the TFEU and the case law of the ECJ. This will be examined in the following.

4.2.7. The Simultaneous Application of the Basic Freedoms

In general, it may be possible that certain activities and investments are protected by more than one of the basic freedoms simultaneously. In such a situation, the question arises whether it is required to stipulate any form of order among the different basic freedoms, i.e. whether one of the basic freedoms prevails over another basic freedom. It is obvious, however, that the basic freedoms which are of importance in the context of this study may only have a certain "overlapping scope of application" but they are not identical in their full scope. Of course, the freedom of establishment, the freedom to provide services, and the free movement of capital all provide the protection from any form of discrimination and restriction, and in this respect any order would not really play a significant role. However, the question whether one of the basic freedoms excludes the application of another basic freedom can be relevant with respect to (possible) justifications for a restriction on the basic freedoms. Moreover, the latter question may be of significance for investments in states outside of the European Union. In the following, the relationship among the basic freedoms will be examined based on the TFEU and the case law of the ECJ.

4.2.7.1. The Freedom of Establishment vs. the Free Movement of Capital

The investment in a foreign company which pursues an economic activity can be covered by both the freedom of establishment and the free movement of capital. This is at least true if the shareholder exercises entrepreneurial control with a definite influence over the company's decisions.[225] If this is not the case, i.e. the investor effects only portfolio investment without exercising any form of entrepreneurial control, the freedom of establishment will not be affected. In the *X and Y* case the Court outlined that the free movement of capital is only of relevance in a situation in which Article 49 of the TFEU does not apply due to the insufficient level of participation.[226] Moreover, in a number of cases, the ECJ came to the conclusion that the freedom of establishment was violated, but did not verify the question whether

[225] See in this respect case C-251/98 (*Baars*), paragraph 22.
[226] Case C-436/00 *(X and Y*), paragraph 68.

there was a simultaneous violation of the free movement of capital.[227] This could lead to the impression that the ECJ considers the free movement of capital to be secondary in cases in which a violation of the freedom of establishment exists.[228] In the *X and Y* case the Court made it clear, though, that the free movement of capital needs to be considered only to the extent that *"(...) the national provision at issue is such as to involve a separate restriction, where the Treaty provisions concerning freedom of establishment do not apply."* [229] However, in the case law of the ECJ with respect to the so-called "golden shares"[230] the Court verified first whether the free movement of capital was affected. After concluding that the domestic provision violated the free movement of capital and after verifying possible justifications, the Court outlined that *"to the extent that the legislation in issue involves restrictions on freedom of establishment, such restrictions are a direct consequence of the obstacles to the free movement of capital considered above, to which they are inextricably linked. Consequently, since an infringement of Article 73 b of the EC Treaty has been established, there is no need for a separate examination of the measures at issue in the light of the Treaty rules concerning freedom of establishment."* [231]

However, it is the more recent case law of the ECJ which, in my opinion, provides a better understanding of the relationship and the principles for giving priority (or not) to one of these two basic freedoms. In the *Cadbury Schweppes* case, the *Lasertec* case and the *Test Claimants in the Thin Cap Group Litigation* case, the Court stated clearly that *"(i)f (…) it were to be accepted that the national measure at issue in the main proceedings has restrictive effects on the free movement of capital, such effects must be seen as an unavoidable consequence of the restriction on freedom of establishment (…) and do not justify an examination of that measure in the light of Articles 56 EC to 58 EC*."[232] From the aforementioned case law it can be understood that it is the *national measure* which is decisive for the examination of the exclusive application of the freedom of establishment and *not* just the degree of (actual) influence or participation. In all of the latter cases, the national measure in question required a certain degree of participation:

- *Test Claimants in the Thin Cap Group Litigation* case: the legislation was applicable in case of participations of at least 75 percent and (in the amended version) in case of common control;[233]

[227] See, inter alia, case C-200/98 (*X AB and Y AB v Riksskatteverket*), November 18, 1999, ECR 1999 page I-08261; case C-264/96 (*Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer*), July 16, 1998, ECR 1998 page I-4695; case C-251/98 (*C. Baars v Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem*), April 13, 2000, ECR 2000 page I-2787.

[228] See in this respect Saß, Zum Schutz von Kapitalbewegungen in der EU gegen steuerliche Diskriminierung, Finanz-Rundschau 2000, page 1270 et seq. (1271). In case C-374/04 (*Rewe Zentralfinanz eG*), paragraph 71, the ECJ outlined that *"(s)ince the provisions of the Treaty relating to freedom of establishment thus preclude national legislation such as the legislation at issue in the main proceedings, it is not necessary to consider whether the provisions of the Treaty relating to free movement of capital also preclude that legislation."*

[229] Case C-436/00 *(X and Y)*, paragraph 66.

[230] Case C-483/99 (*Commission of the European Communities v French Republic*), June 4, 2002, ECR 2002 page I-04781; case C-367/98 (*Commission of the European Communities v Portuguese Republic*), June 4, 2002, ECR 2002 page I-04731), Kiemel in Groeben, Kommentar zum EU/EG Vertrag, Article 56, paragraph 20.

[231] Case C-483/99 (*Commission v France*), paragraph 56. See in this respect also case C-364/01 (*Barbier*), paragraph 75.

[232] Case C-492/04 (*Lasertec*), paragraph 25; see also case C-196/04 (*Cadbury Schweppes*), paragraph 33 and case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), paragraph 34.

[233] Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), paragraphs 29, 30. See with respect to this case also Aitken, The "Thin Cap" End of the Wedge?, Tax Planning International Review 2006, page 12; Fontana, Direct Investments and Third Countries: Things are Finally Moving… in the Wrong Direction,

- *Cadbury Schweppes* case: the CFC legislation was applicable - at that time - to holdings of more than 50 percent;[234]

- *Lasertec:* the German thin-cap legislation was applicable to "significant holdings" - which were (direct or indirect) holdings of more than 25 percent. However, the legislation was also applicable in case the shareholder was holding more than 25 percent together with other shareholders "*with whom he forms an association or by whom he is controlled, whom he controls, or, who, together with him, are controlled. A shareholder with no significant holding shall be treated in the same way as a shareholder with a significant holding where he exercises, either independently or in collaboration with other shareholders, a controlling influence over the company limited by shares.*"[235]

Clearly, the national measures in the *Test Claimants in the Thin Cap Group Litigation* case and the *Cadbury Schweppes* case were structured in a way that - in order to be applicable - the shareholder had to have a definite influence on the decisions of the companies concerned. That means the intention of the respective legislation is to be applicable to investments through which the shareholder has sufficient influence on the activities and this, of course, is - at the same time - what the application of the freedom of establishment requires. On the other hand, the national measure in the *Lasertec* case might not only be applicable to situations in which a definite influence exists from the perspective of Article 49 of the TFEU. This will at least be the case if one takes the position that the freedom of establishment, in principle, requires a majority shareholding and not merely a participation of more than 25 percent (or even less - depending on the situation). However, I think, first of all, that it is not the exact percentage which plays a role in this context. It seems that the ECJ rather focuses on the *purpose* of the national legislation in question than on mere quantitative aspects. The national legislation in the *Lasertec* case nonetheless focused on a *controlling influence* (see above) and was not applicable to shareholdings of up to 25 percent if the additional requirements were not fulfilled. Hence, it remains the intention to target entrepreneurial investments, and not just portfolio investments. At least, what is obvious is the fact that in all of the three cases - where the national measures

European Taxation 2007, page 431 et seq.; Whitehead, A Definite Resemblance, International Tax Review 2007, page 43 et seq.; Whitehouse, The UK and Non-EU States: Fortress Europe?, The Tax Journal 2007, page 21 et seq.; Boutell / Nichols, European Court Supports UK Thin Capitalisation Rules, Tax Planning International European Tax Service 2007, pages 25, 26.

[234] Case C-196/04 (*Cadbury Schweppes*), paragraph 6.

[235] Case C-492/04 (*Lasertec*), paragraph 4. See with respect to this case also Rehm / Nagler, Ist Par. 8a KStG a.F. weltweit nicht mehr anwendbar?: Folgen des Lasertec-Beschlusses des FG Baden-Württemberg vom 14.10.2004, Internationales Steuerrecht 2005, page 261 et seq.; Schnitger, Die Kapitalverkehrsfreiheit in Verhältnis zu Drittstaaten: Vorabentscheidungsersuchen in den Rs. van Hilten, Fidium Finanz AG und Lasertec, Internationales Steuerrecht 2005, page 493 et seq.; Lüdicke, Pending Cases Filed by German Courts I: The Lasertec Case, in ECJ - Recent Developments in Direct Taxation, 2006, page 143 et seq.; Köhler / Tippelhofer, Kapitalverkehrsfreiheit auch in Drittstaatenfällen? Zugleich Anmerkung zu den Entscheidungen des EuGH in den Rechtssachen Lasertec (C-492/04) und Holböck (C-157/05) sowie zum BMF-Schreiben v. 21.3.2007 (IV B 7 – G 1421/0), Internationales Steuerrecht 2007, page 645 et seq.; Schraufl, Dies Auswirkungen der Konkurrenz zwischen Niederlassungs- und Kapitalverkehrsfreiheit auf Drittstaatensachverhalte im Steuerrecht: Zugleich Anmerkungen zum EuGH-Beschluss vom 10.5.2007, Recht der Internationalen Wirtschaft 2007, 632 - Lasertec, Recht der Internationalen Wirtschaft 2007, page 603 et seq.; Eicker / Obser, Lasertec Shows ECJ Reluctance, International Tax Review 2007, page 23; Cordewener / Kofler / Schindler, Free Movement of Capital and Third Countries: Exploring the Outer Boundaries With *Lasertec, A and B* and *Holböck*, European Taxation 2007, page 371 et seq.; Fontana, ECJ concludes German Thin Cap Legislation compatible with EC Law with respect to Third States: Lasertec, Tax Planning International European Tax Service, June 2007.

required a (certain) controlling or definite influence - the ECJ exclusively examined the freedom of establishment and rejected the examination of the respective legislation in the light of the free movement of capital.[236] The approach was confirmed, *inter alia*, in the *Stahlwerk Ergste Westig* decision[237] which, however, did not deal with the participation in foreign legal entities but with foreign permanent establishments.[238] In this decision as well, the ECJ solely concentrated on the freedom of establishment and - after coming to the conclusion that the latter freedom was not affected in case of an investment in a non-member state - did *not* examine the free movement of capital.[239] At first glance, it seems that the outcome of the *Stahlwerk Ergste Westig* case is in line with the aforementioned decisions only if one agrees with the Court that the relevant provisions are intended to be applicable to participations - in this case transparent partnerships - which confer a definite influence.[240] However, the relevant treaty provisions are not connected to a certain minimum participation, i.e. the exemption would also be granted in case of a very small interest in the US partnerships.[241] For this reason, one might be tempted to argue that it is the intention that the relevant provisions focus on entrepreneurial and non-entrepreneurial investments and, theoretically, an examination of the free movement of capital could have been made as well. After *Stahlwerk Ergste Westig* (and also the cases *A and B* and *Lidl Belgium)*[242] one might have the impression that the Court considers Article 49 of the TFEU to be applicable exclusively in case of a permanent establishment, but this would be in contradiction to the *Columbus Container* decision where the general application of Article 49 and Article 63 of the TFEU was, in principle, accepted.[243] However, I think the decisive point in *Stahlwerk Ergste Westig* is the fact that the legislation - although not connected to a certain minimum participation - is closely linked to the objective of exercising the freedom of

[236] See in this respect also Köhler / Tippelhofer, Kapitalverkehrsfreiheit auch in Drittstaatenfällen?, Internationales Steuerrecht 2007, page 645 et seq.; Wellens, Nichtabziehbare Betriebsausgaben bei Drittlandsdividenden - Kapitalverkehrsfreiheit contra Niederlassungsfreiheit, Deutsches Steuerrecht 2007, page 1852 et seq.

[237] Case C-415/06 (*Stahlwerk Ergste Westig GmbH v Finanzamt Düsseldorf-Mettmann*), November 6, 2007. See with respect to this case also Tetzlaff / Schallock, Abzug von Verlusten ausländischer Betriebsstätten in Deutschland möglich?, Internationale Wirtschafts-Briefe 2006, Fach 3, Gruppe 2, page 1326 et seq.; Lüdicke, Pending Cases Filed by German Courts: The *Meilicke, Burda, Gronfeldt, Jäger, Heinrich Bauer Verlag, Rewe Zentralfinanz, Lidl Belgium, Stahlwerk Ergste Westig and Deutsche Shell* Cases, in ECJ - Recent Developments in Direct Taxation, 2007, page 47 et seq.; Arginelli / Gusmeroli, The 2007 Leiden Alumni Forum on Recent and Pending Direct Taxation Cases Before the European Court of Justice, Intertax 2008, page 312 et seq.; EuGH-Entscheidungen, Abziehbarkeit von Betriebsstättenverlusten aus Drittstaaten, Internationales Steuerrecht 2008, page 107 et seq.; Rehm / Nagler, Neues von der grenzüberschreitenden Verlustverrechnung!, Internationales Steuerrecht 2008, page 129 et seq.

[238] The company held two 100 percent participations in US-(transparent) partnerships (case C-415/06 (*Stahlwerk Ergste Westig*), paragraph 3).

[239] Case C-415/06 (*Stahlwerk Ergste Westig*), paragraphs 16-19.

[240] See case C-415/06 (*Stahlwerk Ergste Westig*), paragraph 15.

[241] Articles 7 (1) and 23 (2) letter a of the German-US double tax convention.

[242] Case C-102/05 (*A and B*), May 10, 2007; case C-414/06 (*Lidl Belgium*), May 15, 2008. See with respect to case C-102/05 (*A and B*) also Cordewener / Kofler / Schindler, Free Movement of Capital and Third Countries: Exploring the Outer Boundaries with *Lasertec, A and B* and *Holböck*, European Taxation 2007, page 371 et seq. (374).

[243] See case C-298/05 (*Columbus Container*), paragraphs 55 to 57. I will not go into further detail of this question with respect to permanent establishments since it is not of particular relevance for this study. See with regard to the contradiction in the jurisprudence of the ECJ also Tippelhofer / Lohmann, Niederlassungsfreiheit vs. Kapitalverkehrsfreiheit: Analyse der jüngeren Rechtsprechung des EuGH zu den direkten Steuern, Internationales Steuerrecht 2008, page 857 et seq. (861). See also Obser, Deutsches Steuerrecht 2008, page 1088.

establishment. This becomes clearer after the *Glaxo Wellcome* decision, which will be outlined below.[244]

In principle, the above conclusions are supported by the fact that in the *Test Claimants in the FII Group Litigation* case, the *Holböck* case and the *Lammers & Van Cleeff* case the ECJ did *not* reject the examination of the free movement of capital in those situations in which no definite influence was requested by the respective legislation.[245] In the *Test Claimants in the FII Group Litigation* case the ECJ held, inter alia, that *"(s)ince the legislation applies to payments of dividends to shareholder companies irrespective of the size of the holding, it is capable of coming under both Article 43 EC on the freedom of establishment and Article 56 on the free movement of capital. However, to the extent to which the holdings in question confer on their owner a definite influence over the decisions of the companies concerned and allow it to determine their activities, it is the provisions of the Treaty relating to freedom of establishment which apply."*[246] In other words, both basic freedoms can be relevant, but due to the fact that a definite influence exists (although it is not required by the national legislation) the ECJ starts its examination with the freedom of establishment. In the *Holböck* case, the approach of the ECJ becomes even clearer: *"(a)s regards the question whether national legislation falls within the scope of one or other of the freedoms of movement, it is clear from what is now well established case-law that the purpose of the legislation must be taken into consideration (…). Unlike the situations in Cadbury Schweppes and (…) Test Claimants in the Thin Cap Group Litigation (…), the Austrian legislation in the present case is not intended to apply only to those shareholdings which enable the holder to have a definite influence on a company's decisions and to determine its activities. National legislation which makes the receipt of dividends liable to tax, where the rate depends on whether the source of those dividends is national or otherwise, irrespective of the extent of the holding which the shareholder has in the company making the distribution, may fall within the scope of both Article 43 EC (…) and Article 56 EC (…)."*[247] The fact that the Court accepts, in general, that both freedoms may be affected can be of particular relevance in cases in which countries outside of the EU are involved. In the *Test Claimants in the FII Group Litigation* case as well as in the *Holböck* case, the ECJ examined the free movement of capital only after coming to the conclusion that the freedom of establishment could not be invoked in situations in which non-member countries were

[244] Case C-182/08 (*Glaxo Wellcome GmbH & Co. KG v Finanzamt München II*), September 17, 2009.

[245] In case C-446/04 (*Test Claimant in the FII Group Litigation*) the ECJ had to deal with a number of questions referring to different national legislation - with and without the requirement of a certain percentage of shareholding.

[246] Case C-446/04 (*Test Claimants in the FII Group Litigation*), paragraphs 80, 81.

[247] Case C-157/05 (*Holböck*), paragraphs 22, 23 and 24. See with respect to this case also Staringer, Pending Cases Filed by Austrian Courts: The Holböck Case, in ECJ - Recent Developments in Direct Taxation, 2006, page 9 et seq.; Fontana, Direct Investments and Third Countries: Things are Finally Moving… in the Wrong Direction, European Taxation 2007, page 431 et seq.; Köhler / Tippelhofer, Kapitalverkehrsfreiheit auch in Drittstaatenfällen? Zugleich Anmerkung zu den Entscheidungen des EuGH in den Rechtssachen Lasertec (C-492/04) und Holböck (C-157/05) sowie zum BMF-Schreiben v. 21.3.2007 (IV B 7 – G 1421/0), Internationales Steuerrecht 2007, page 645 et seq.; Cordewener / Kofler / Schindler, Free Movement of Capital and Third Countries: Exploring the Outer Boundaries With *Lasertec, A and B* and *Holböck*, European Taxation 2007, page 371 et seq.; Marschner, Die Freiheit des Kapitalverkehrs mit Drittstaaten: eine Analyse des EuGH-Urteils Holböck, Finanz Journal 2007, page 359 et seq.; Hohenwarter / Plansky, Die Kapitalverkehrsfreiheit mit Drittstaaten im Lichte der Rechtssache Holböck, Steuer und Wirtschaft International 2007, page 346 et seq.; O'Shea, Holböck: Austrian Dividend Tax Rules Found Compatible With the EC Treaty, Tax Notes International 2007, page 1131 et seq.

involved.[248] I will come back to the aspects which are of importance in case of investments in non-member states below. In the *Lammers & Van Cleeff* case - where no third countries were involved - the ECJ first examined the freedom of establishment.[249] After the conclusion that the national measure resulted in a restriction on the freedom of establishment which cannot be justified, the ECJ did not see the necessity to examine, in addition, whether the Treaty provisions on the free movement of capital also preclude the respective legislation.[250]

In the *Burda* decision[251] the ECJ concluded that the respective national legislation may fall within the purview both of the freedom of establishment and the free movement of capital, because the legislation does not depend on the extent of the holding which the company receiving the dividend has in the company paying it.[252] However, in the following the ECJ determined an 'exclusive' application of the freedom of establishment and concluded that a restriction of the free movement of capital is just an unavoidable consequence of an obstacle to the freedom of establishment.[253] That means the fact that the company had a 50 percent participation resulted in an exclusive application of Article 49 of the TFEU, even though the purpose of the legislation is the general application to portfolio and entrepreneurial investments. The situation in the *SGI* case was very similar: the legislation in question was not dependent on the percentage of shareholding.[254] So, theoretically, both Article 49 and Article 63 of the TFEU could have been relevant. However, also in this case the ECJ decided that - based on the fact that the companies involved had a 'definite influence' within the meaning of the *Baars* case-law - it was necessary to answer the question 'solely' in the light of the freedom of establishment.[255] Looking at the *Burda* and *SGI* decisions, the exclusive application of Article 49 TFEU in those cases where a 'definite influence' exists might restrict the relevance of Article 63 TFEU. According to Haslehner and Kofler, this would mean that the protection under the free movement of capital would be inversely proportional to the extent of participation.[256] Pursuant to Hemels et al. it is the question whether the strict focus on one freedom is in accordance with the purpose of the Treaty.[257] Tippelhofer and Lohmann concluded that the *Burda* decision might be based on the fact that the national rules concern only relationships within a group of companies.[258]

[248] Case C-157/05 (*Holböck*), paragraphs 29 et seq.; case C-446/04 (*Test Claimants in the FII Group Litigation*), paragraph 165.
[249] Case C-105/07 (*Lammers & Van Cleeff*), paragraphs 15 to 17.
[250] Case C-105/07 (*Lammers & Van Cleeff*), paragraph 35.
[251] Case C-284/06 (*Finanzamt Hamburg-Am Tierpark v Burda GmbH*), June 26, 2008.
[252] Case C-284/06 (*Burda*), paragraph 71.
[253] Case C-284/06 (*Burda*), paragraphs 72 to 75.
[254] Case C-311/08 (*SGI)*, paragraph 29.
[255] Case C-311/08 (*SGI*), paragraphs 36, 37.
[256] Haslehner, Das Konkurrenzverhältnis der Europäischen Grundfreiheiten in der Rechtsprechung des EuGH zu den direkten Steuern, Internationales Steuerrecht 2008, page 565 et seq. (575); see in this respect also Sedemund, Betriebs-Berater 2008, page 1830, 1831; Rehm / Nagler, Anmerkungen zum nachstehenden EuGH-Urteil "Burda" S. 515, Internationales Steuerrecht 2008, page 511 et seq.
[257] Hemels et al., Freedom of Establishment or Free Movement of Capital: Is There an Order of Priority? Conflicting Visions of National Courts and the ECJ, EC Tax Review 2010, page 19 et seq. (31).
[258] Tippelhofer / Lohmann, Niederlassungsfreiheit vs. Kapitalverkehrsfreiheit: Analyse der jüngeren Rechtsprechung des EuGH zu den direkten Steuern, Zugleich Anmerkungen zum EuGH-Urteil in der Rechtssache *Burda* (C-284/06), Internationales Steuerrecht 2008, page 857 et seq. (862).

However, in order to complete the picture it is important to have a look at the *Glaxo Wellcome* case, too.[259] The case itself deals with the restructuring of the German part of the *Glaxo Wellcome* group. Here, the ECJ stated that the relevant German legislation did not depend on the size of the holdings acquired and was not limited to situations in which the shareholder could exercise definite influence on the decisions of the company concerned and determine its activities.[260] Furthermore, the ECJ concluded that *"(…) the purpose of the legislation (…) is to prevent resident shareholders from obtaining an undue tax advantage directly through the sales of shares with the sole objective of obtaining that advantage, and not with the objective of exercising the freedom of establishment or as a result of exercising that freedom, it must be held that the free movement of capital aspect of that legislation prevails over that of the freedom of establishment."*[261] Consistently, the ECJ proceeded with an exclusive examination of the free movement of capital.[262] In my opinion, the case is important, because it confirms that the ECJ strictly focuses on the purpose of the legislation and - even though the freedom of establishment might theoretically be relevant as well - the Court did not give preference to Article 49 of the TFEU just because of the fact that the case deals with a group structure in which the requirement of a 'definite influence' is existent. In other words, the purpose of the legislation remains the decisive element for the decision whether Article 49 or Article 63 of the TFEU will be examined.[263]

In my opinion, the conclusions which can be drawn from the case law outlined above are the following:

- The purpose of the national legislation must be considered for the decision which of the basic freedoms is affected. This is the most decisive element.

- If the purpose of the legislation is the application to investments which confer a definite influence over a company's decisions, it is the freedom of establishment which is to be exclusively examined. The purpose of the legislation can be identified not only by quantitative elements (e.g. the percentage of participation), but also by qualitative elements (e.g. the collaboration of shareholders to achieve a definite influence).[264]

- If the purpose of the legislation is the general application to all types of portfolio and entrepreneurial investments, the freedom of establishment and the free movement of capital can, in principle, both be affected.

- However, if the actual investment confers definite influence over a company's decisions and the purpose of the legislation is linked to the objective of exercising the freedom of establishment, the ECJ gives preference to the freedom of

[259] Case C-182/08 (*Glaxo Wellcome GmbH & Co. KG v Finanzamt München II*), September 17, 2009.
[260] Case C-182/08 (*Glaxo Wellcome*), paragraph 49.
[261] Case C-182/08 (*Glaxo Wellcome*), paragraph 50.
[262] Case C-182/08 (*Glaxo Wellcome*), paragraphs 51, 52.
[263] However, it is apparent that the question whether the freedom of establishment or the free movement of capital applies remains a relatively complex question and may lead to confusion on the level of national courts. See with respect to the differing approaches of national courts Den Boer, Freedom of Establishment versus Free Movement of Capital: Ongoing Confusion at the ECJ and in the National Courts?, European Taxation 2010, page 250 et seq. and Hemels et al., Freedom of Establishment or Free Movement of Capital: Is There an Order of Priority? Conflicting Visions of National Courts and the ECJ, EC Tax Review 2010, page 19 et seq.
[264] See also Köhler / Tippelhofer, Internationales Steuerrecht 2007, page 645 et seq. (649).

establishment. In contrast thereto, if the aforementioned link does not exist and the '*free movement of capital aspect'* prevails, the ECJ gives preference to the free movement of capital.[265]

- If the examination of the legislation results in the conclusion that a restriction on one of the freedoms exists which cannot be justified, the ECJ refrains from additionally examining whether the TFEU provisions on the other freedom also preclude the respective legislation.

4.2.7.2. The Freedom of Establishment vs. the Freedom to Provide Services

The freedom of establishment requires the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period of time whereas the freedom to provide services requires the actual pursuit of an economic activity either from within the Member State of primary establishment towards the recipient in another Member State or with a temporary connection to the Member State of the recipient. The investment in a service company in another Member State, for example, should therefore - if all the aforementioned requirements are fulfilled - come within the scope of the freedom of establishment but not at the same time within the scope of the freedom to provide services. The reason is that in a typical situation the economic activity is pursued through a fixed establishment in another Member State. On the other hand, the services supplied by the company to other related or unrelated recipients situated in other Member States will come within the scope of the freedom to provide services since they will not be pursued through a fixed establishment in the Member State of the recipient of the services (which could be a "third" Member State or even the Member State of the investor). In case of a service company it is therefore likely that the freedom of establishment and the freedom to provide services are both applicable, but not necessarily to the same entity and not in the same "direction." In those cases in which both freedoms are affected simultaneously, one might be tempted to conclude that Article 57 (1) of the TFEU gives preference to the right of establishment. However, the more recent case law does not support such a conclusion. In the *Fidium Finanz* decision[266] the Court clearly stated that Article 57 (1) of the TFEU relates to the definition of the notion of 'services' and does *not* establish any order of priority between the freedom to provide services and the other fundamental freedoms. Pursuant to the Court, the notion of 'services' covers services which are not governed by other freedoms, in order to ensure that all economic activity falls within the scope of the fundamental freedoms.[267] In the *Cadbury Schweppes* case the ECJ concluded that if CFC legislation *"(...) has restrictive effects on the free movement of services and the free movement of capital, such effects are an unavoidable consequence of any restriction on freedom of establishment and do not justify, in any event, an independent examination of that legislation in the light of Articles 49 EC and 56 EC."*[268]

[265] See in this regard C-182/08 (*Glaxo Wellcome*), paragraph 50.
[266] Case C-452/04 (*Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht*), October 3, 2006, ECR 2006, page I-9521.
[267] Case C-452/04 (*Fidium Finanz*), paragraph 32.
[268] Case C-196/04 (*Cadbury Schweppes*), paragraph 33. See in this respect also case C-524/04 (*Test Claimants*), paragraph 34.

4.2.7.3. The Freedom to Provide Services vs. the Free Movement of Capital

The difference between the freedom to provide services and the free movement of capital can be minor and according to the "older" case law of the ECJ it seems as if both freedoms can be applied simultaneously. In *Svensson*[269] the Court stated that *"(i)t should also be noted that by virtue of Article 61 (2) of the Treaty "the liberalization of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalization of movement of capital." Since transactions such as building loans provided by banks constitute services within the meaning of Article 59 of the EC Treaty, it is also necessary to ascertain whether the rule referred to by the national court is compatible with the Treaty provisions on freedom to provide services.*"[270] Furthermore, in *Safir* [271] the Court concluded that the freedom to provide services precludes the application of legislation in a Member State which provides for different tax regimes for capital life assurance policies, depending upon whether they are taken out with companies established in that Member State or with companies established elsewhere. Interestingly, the Court did not even see any necessity to verify whether the free movement of capital could be affected simultaneously after coming to the conclusion that an unjustified violation of the freedom to provide services existed.[272] The same was true in the subsequent *Skandia* case.[273] However, it seems that in situations in which the purpose of a transfer could not be determined the ECJ considered the free movement of capital to be applicable.[274]

[269] Case C-484/93 (*Peter Svensson et Lena Gustavsson v Ministre du Logement et de l'Urbanisme*), November 14, 1995, ECR 1995 page I-3955.
[270] Case C-484/93 (*Svensson and Gustavsson*), paragraph 11.
[271] Case C-118/96 (*Jessica Safir v Skattemyndigheten I Dalarnas Län, formerly Skattemyndigheten I Kopparbergs Län*), April 28, 1998, ECR 1998 page I-01897.
[272] Case C-118/96 (*Safir)*, paragraph 35; according to Cordewener nothing is included in the decision which indicates than one of the basic freedoms prevails over the other, or which gives exclusivity to one of the basic freedoms in question (Cordewener, Europäische Grundfreiheiten und nationales Steuerrecht, page 585); see in this respect also Toifl, Steuer und Wirtschaft International 1998 page 261; see the detailed verification of Advocate General Tesauro, Opinion of the Advocate General (case C-118/96, *Safir*), September 23, 1997, paragraphs 8-19. Advocate General Tesauro outlined that *"(i)t is clear from an examination of the rules governing the freedom to provide services and the free movement of capital, their place in the Treaty and a careful reading of all the relevant case-law that the provisions of Article 59 et seq., on the one hand, and of Article 73b et seq., on the other, are not intended to apply cumulatively and still less indiscriminately, but that they govern, at least in principle, different cases: the first require abolition of all restrictions on the free provision of services - including financial services - within the Community whereas the second prohibit all restrictions on the free movement of capital and payments (...). As a result, the compatibility with Community law of the national legislation at issue should - unless it simultaneously hinders both the free provision of services and the free movement of capital - be examined under either Article 59 et seq. or under Article 73b et seq.*" (see the Opinion of the Advocate General Tesauro, paragraph 9).
[273] Case C-422/01 (*Skandia*), paragraph 60: "*In the light of the foregoing observations, there is no need to assess whether the provisions of the Treaty on the free movement of persons and capital preclude national legislation such as that at issue in the main proceedings."*
[274] Kiemel in Groeben, Kommentar zum EU/EG Vertrag, Article 56, paragraph 22; case C-358/93 and C-416/93 (*Criminal proceedings against Aldo Bordessa and Vicente Mari Mellado and Concepcion Barbero Maestre*), February 23, 1995, ECR 1995, page I-0361; case C-302/97 (*Konle*), June 1, 1999, ECR 1999 page I-3101.

In the more recent *Fidium Finanz* decision,[275] the ECJ went into more detail of the question of a simultaneous application of the two freedoms. *Fidium Finanz AG*, a Swiss company, granted credits mainly to German citizens resident in Germany who met certain criteria.[276] The credits were offered via an internet site operated from Switzerland and credit intermediaries operating in Germany. According to the national court, the intermediaries neither acted as representatives nor as authorised agents of *Fidium Finanz*, but concluded contracts on behalf of that company and were paid commissions.[277] The German *Bundesanstalt für Kreditwesen* prohibited *Fidium Finanz* from carrying on lending activities on a commercial basis since the latter did not fulfil the requirements of the German *Kreditwesengesetz (KWG)*.[278] In essence, the national court submitted the question to the ECJ whether the granting of commercial loans through a company established in a non-member country to residents of a Member State might come within the scope of the free movement of capital and / or the freedom to provide services.[279] In this respect, the ECJ stated that *"(w)here a national measure relates to the freedom to provide services and the free movement of capital at the same time, it is necessary to consider to what extent the exercise of those fundamental liberties is affected and whether, in the circumstances of the main proceedings, one of those prevail over the other (…). The Court will in principle examine the measure in dispute in relation to only one of those two freedoms if it appears, in the circumstances of the case, that one of them is entirely secondary in relation to the other and may be considered together with it (…).*"[280] Further, the ECJ concluded that *"(…) the activity of granting credit on a commercial basis concerns, in principle, both the freedom to provide services within the meaning of Article 49 EC et seq. and the free movement of capital within the meaning of Article 56 EC et seq.*" [281] Also in this case, the Court verified the purpose of the (German) rules and held that *"(t)he purpose (…) is to supervise the provision of such services and to authorise such provision only for undertakings which guarantee to conduct such transactions properly.*"[282] And *"(t)he rules in dispute prevent economic operators which do not have the qualities required by the KWG from having access to the German financial market. It is settled case law that all measures which prohibit, impede or render less attractive the exercise of the freedom to provide services must be regarded as restrictions on that freedom.*"[283] With respect to a possible restriction on the free movement of capital, the ECJ stated that this was *"(…) merely an unavoidable consequence of the restriction on the freedom to provide services (…). It*

[275] Case C-452/04 (*Fidium Finanz*), October 3, 2006, ECR 2006, page I-9521. See with respect to this case also Schnitger, Die Kapitalverkehrsfreiheit in Verhältnis zu Drittstaaten: Vorabentscheidungsersuchen in den Rs. van Hilten, Fidium Finanz AG und Lasertec, Internationales Steuerrecht 2005, page 493 et seq.; Sedemund, Die mittelbare Wirkung der Grundfreiheiten für in Drittstaaten ansässige Unternehmen nach den EuGH-Urteilen Fidium Finanz AG und Cabury Schweppes: Zugleich eine Anmerkung zum Vorlagebeschluss des BFH vom 22.8.2006 - I R 116/04, Betriebs-Berater 2006, page 2781 et seq.; Thömmes / Nakhai, Berufung auf die Kapitalverkehrsfreiheit für Drittstaatunternehmen, Internationale Wirtschafts-Briefe 2006, Fach 11A, page 1103 et seq.; Whitehouse, The UK and Non-EU States: Fortress Europe?, The Tax Journal 2007, page 21 et seq.; Weber, Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht: The ECJ Gives the Wrong Answer About the Applicability of the Free Movement of Capital Between the EC Member States and Non-Member Countries, British Tax Review 2007, page 670 et seq.

[276] Case C-452/04 (*Fidium Finanz*), paragraphs 14, 15.

[277] Case C-452/04 (*Fidium Finanz*), paragraph 16.

[278] Case C-452/04 (*Fidium Finanz*), paragraphs 17-19.

[279] Case C-452/04 (*Fidium Finanz*), paragraph 20.

[280] Case C-452/04 (*Fidium Finanz*), paragraph 34.

[281] Case C-452/04 (*Fidium Finanz*), paragraph 43.

[282] Case C-452/04 (*Fidium Finanz*), paragraph 45.

[283] Case C-452/04 (*Fidium Finanz*), paragraph 46.

is apparent that, in the circumstances of the main case, the predominant consideration is freedom to provide services rather than free movement of capital. Since the rules in dispute impede access to the German financial market for companies established in non-member countries, they affect primarily the freedom to provide services. Given that the restrictive effects of those rules on the free movement of capital are merely an inevitable consequence of the restriction imposed on the provision of services, it is not necessary to consider whether the rules are compatible with Article 56 et seq."[284] However, since *Fidium Finanz* was established in Switzerland, a non-member country, the Court concluded that the latter company could not rely on the freedom to provide services.[285] Even under these circumstances the Court did not see any necessity for a further - alternative - examination of the free movement of capital. Overall, it seems that - similar to the situation described in the context of the freedom of establishment vs. the free movement of capital - the purpose of the legislation is decisive. If the national legislation clearly focuses on services, e.g. the supervision of services, there is no room for any (additional) examination of the free movement of capital. On the other hand, one should also conclude from this jurisprudence that national legislation which is foremost directed towards the investment (as such) - and not the services provided by the investment (e.g. the respective legal entity) - the prevailing freedom should be the free movement of capital and not the freedom to provide services.

4.2.8. The Basic Freedoms and the Investment in Non-Member States

Whereas the scope of the freedom of establishment and the freedom to provide services is limited to movements and transactions within the EU, Article 63 et seq. of the TFEU prohibits all restrictions on the free movement of capital and payments between Member States and between Member States and third countries.[286] In this respect, it is important to note that not only nationals of a Member State or companies established in a Member State can claim the free movement of capital and payments but also nationals and companies from outside the EU.[287] The extension to capital transfers to and from non-member states gives Article 63 et seq. of the TFEU a somehow unique position within the basic freedoms.[288] The importance of this position becomes even more obvious by the fact that the ECJ considers the free movement of capital - as outlined above - not necessarily to be secondary in relation to the other basic freedoms. It has to be noted, however, that Article 64 (1) of the TFEU provides for a "standstill clause" ("grandfather clause") which allows the Member States to apply restrictive legislation in relation to third countries which already existed on 31st of December 1993. Thus, if a Member State has introduced such legislation before the respective date *and* has not substantially changed that legislation afterwards, there is still the possibility to apply such restrictive legislation to investments in non-member states. I will come back to this clause in the context of the justifications for a restriction on the basic freedoms.

[284] Case C-452/04 (*Fidium Finanz*), paragraphs 48, 49.
[285] Case C-452/04 (*Fidium Finanz*), paragraph 50.
[286] The *erga-omnes* effect of Article 56 et seq. (ex Article 73 b et seq.) to non-member states is applicable as of 1st January 1994.
[287] See also Kiemel in Groeben, Kommentar zum EU/EG Vertrag, Article 56, paragraph 26; Seidel, Recht und Verfassung des Kapitalmarktes, page 772.
[288] See in this respect Schön, Der Kapitalverkehr mit Drittstaaten, 2005, page 499 et seq. (492).

In principle, the free movement of capital can be invoked (i) if it is the only freedom which is affected, (ii) if it prevails of another basic freedom or (iii) if it can be applied simultaneously. However, if the purpose of the national legislation is the application to investments which confer a definite influence over a company's decisions and the legislation is linked to the objective of exercising the freedom of establishment, the ECJ examines the freedom of establishment and not, simultaneously, the free movement of capital. The same is true if the national legislation is intended to be applied to services, e.g. the supervision of services. Here, the ECJ gives preference to the freedom to provide services without any alternative examination of the free movement of capital. In my opinion, the more recent case law of the ECJ - as outlined above - shows that the free movement of capital plays a less important role than it could be understood from the mere wording of the TFEU. According to Smit, the categorical exclusion of a substantial number of third country investments from the scope of the free movement of capital makes it impossible to fully serve the underlying goal of the latter freedom, namely the achievement of an optimal geographical distribution of economic activity[289] and therefore the improving of global welfare.[290] A number of authors consider the fact that the ECJ creates a framework of protection which is inversely proportional to the size of the investment to be critical.[291] Pursuant to Wimpissinger, the scope of the freedom of establishment is broader than the scope of the free movement of capital. The freedom of establishment, therefore, generally includes the free movement of capital with the consequence that if the freedom of establishment cannot be applicable only because of the third country context, the narrower freedom should be applicable.[292] Panayi went in the same direction and raised the (rhetorical) question whether - in case two freedoms were potentially breached but only one was inapplicable - it would not be logical for the ECJ to proceed to examine whether or not the other freedom was affected.[293] Stahl concluded that if a national measure is consistent with one basic freedom, it is nevertheless necessary to proceed and examine the national measure against the other applicable basic freedom.[294] However, this is not necessarily the case - taking into account the jurisprudence of the ECJ. Of course, this may have important consequences for the investments in non-member states and may "close the door" for the treaty protection under the free movement of capital. On the other hand, what is clear from the more recent case law - and in particular from the *Glaxo Wellcome* case - is the fact that the purpose of the national legislation remains the decisive

[289] Lundström, Capital Movements and Economic Integration, 1961, page 38.

[290] Smit, The Relationship between the Free Movement of Capital and the other EC Treaty Freedoms in Third Country Relationships in the Field of Direct Taxation: A Question of Exclusivity, Parallelism or Causality?, EC Tax Review 2007, page 252 et seq. (267).

[291] See, *inter alia*, Schön, Der Kapitalverkehr mit Drittstaaten und das internationale Steuerrecht, in Gocke / Gosch / Lang (eds.), Körperschaftsteuer-Internationales Steuerrecht-Doppelbesteuerung, Festschrift für F. Wassermeyer, 2005, page 499 et seq. (501); Rehm / Nagler, Verbietet die Kapitalverkehrsfreiheit nach 1993 eingeführte Ausländergleichbehandlung?, Internationales Steuerrecht 2006, page 861; Cordewener / Kofler / Schindler, Free Movement of Capital and Third Countries: Exploring the Outer Boundaries with *Lasertec, A and B and Holböck*, European Taxation 2007, page 371 et seq. (374); Haslehner, Das Konkurrenzverhältnis der Europäischen Grundfreiheiten in der Rechtsprechung des EuGH zu den direkten Steuern, Internationales Steuerrecht 2008, page 565 et seq. (575); Sedemund, Betriebs-Berater 2008, page 1830, 1831; Rehm / Nagler, Anmerkungen zum nachstehenden EuGH-Urteil "Burda" S. 515, Internationales Steuerrecht 2008, page 511 et seq.

[292] Wimpissinger, Cross-Border Transfer of Losses, the ECJ does not agree with Advocate General Sharpston, EC Tax Review 2008, page 173 et seq. (174).

[293] Panayi, The Fundamental Freedoms and Third Countries: Recent Perspectives, European Taxation 2008, page 571 et seq. (573).

[294] Stahl, Free Movement of Capital between Member States and Third Countries, EC Tax Review 2004, page 49.

element for the decision whether the freedom of establishment or the free movement of capital will be examined. Consequently, if the national legislation is not linked to the objective of exercising the freedom of establishment and the '*free movement of capital aspect'* prevails, there will be an exclusive examination of the free movement of capital.[295]

4.2.9. The Abuse of the Basic Freedoms

It is quite obvious that the basic freedoms confer important rights to individuals and entities with respect to cross-border investments and services. It is therefore equally obvious that situations exist in which the basic freedoms are abusively invoked just for the purpose of taking advantage of these rights without being entitled to do so. The Member States may therefore apply rules which prevent the circumvention of national legislation by abusively invoking EU law. However, the case law of the ECJ clearly shows that, for example, the abuse of the freedom of establishment must be determined on a case-by-case basis and cannot be generalised. In the *Centros* case[296] the ECJ stated that *"(i)t is true that according to the case-law of the Court a Member State is entitled to take measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community Law.(...) However, although, in such circumstances, the national courts may, case by case, take account - on the basis of objective evidence - of abuse or fraudulent conduct on the part of the persons concerned in order, where appropriate, to deny them the benefit of the provisions of Community law on which they seek to rely, they must nevertheless assess such conduct in the light of the objectives pursued by those provisions.(...) (T)he fact that a national of a Member State who wishes to set up a company chooses to form it in the Member State whose rules of company law seem to him the least restrictive and to set up branches in other Member States cannot, in itself, constitute an abuse of the right of establishment."* [297]

In the *X and Y* case the ECJ pointed out that a national provision which *"(...) excludes categorically and generally any (...) share transfer from the benefit of deferral of tax, does not allow national courts to make such a case-by-case analysis taking account of the particular features of each case*."[298] Furthermore, and very important, *"(...) the criterion on the basis of which the national provision excludes (...) share transfers from that tax advantage - namely the fact that the transfer is to a company established under the legislation of another Member State or a branch set up in Sweden by such a company - relates to the exercise of the freedom of establishment guaranteed by the Treaty and cannot, therefore, in itself, constitute an abuse of the*

[295] See, in particular, case C-182/08 (*Glaxo Wellcome*), paragraphs 49 to 52.
[296] Case C-212/97 (*Centros Ltd v Erhvervs- og Selskabsstyrelsen*), March 9, 1999, ECR 1999 page I-01459. See with respect to this case also Göttsche, Das Centros-Urteil des EuGH und seine Auswirkungen, Deutsches Steuerrecht 1999, page 1403 et seq.; Geyrhalter, Niederlassungsfreiheit contra Sitztheorie - Good Bye "Daily Mail"?, in Europäisches Wirtschafts- und Steuerrecht 1999, page 201 et seq.; Fock, Sitztheorie im deutschen internationalen Steuerrecht nach der Centros-Entscheidung, Recht der Internationalen Wirtschaft 2000, page 42 et seq.; Werlauff, The Conseequences of the Centros Decision: Ends and Means in the Protection of Public Interests, European Taxation 2000, page 542 et seq.; Kussmaul / Ruiner, Ausgewählte Charakteristika der Limited mit ausschließlicher Geschäftstätigkeit in Deutschland im Licht der aktuellen Gesetzesänderungen, Internationales Steuerrecht 2007, page 696 et seq.
[297] Case C-212/97 (*Centros*), paragraphs 24, 25 and 27.
[298] Case C-436/00 *(X and Y*), paragraph 43.

right of establishment."[299] In the *Lasteyrie du Saillant* case the Court held that *"(...) a national measure should not presume, as in the present case, that the freedom of establishment under Community law is being exercised fraudulently, although it could provide for the possibility of the tax authorities demonstrating on a case-by-case basis there is actual tax evasion or avoidance*."[300]

It is also clear from the case law of the ECJ that the reasons for the establishment in another Member State are, in principle, irrelevant - with the exception of fraud. In the *Inspire Art* case, the Court stated - based on the earlier *Centros* and *Segers* decisions - that *"(...) it is immaterial, having regard to the application of the rules on freedom of establishment, that the company was formed in one Member State only for the purpose of establishing itself in a second Member State, where its main, or indeed entire, business is to be conducted (...). The reasons for which a company chooses to be formed in a particular Member State are, save in the case of fraud, irrelevant with regard to application of the rules on freedom of establishment (...). The Court has also held that the fact that the company was formed in a particular Member State for the sole purpose of enjoying the benefit of more favourable legislation does not constitute abuse even if that company conducts its activities entirely or mainly in that second State (...)*."[301] The jurisprudence of the ECJ was once more confirmed in the *Cadbury Schweppes* case. According to the Court, the fact that an EU national *"(...) sought to profit from tax advantages in force in a Member State other than his State of residence cannot in itself deprive him of the right to rely on the provisions of the Treaty*."[302] And *"(...) it follows that the fact that in this case CS decided to establish CSTS and CSTI in the IFSC for the avowed purpose of benefiting from the favourable tax regime which that establishment enjoys does not in itself constitute abuse.*"[303]

Additional information and guidance may be obtained from the case law of the ECJ in the field of indirect taxation. In the *Halifax* case, the Court stated that, in the context of the interpretation of the 6th VAT Directive, an *abusive practice* can be held to exist where:

- the transactions concerned, notwithstanding the formal application of the conditions laid down by the relevant provisions of the 6th VAT Directive and the national legislation transposing it, result in the accrual of a tax advantage the granting of which would be contrary to the purpose of those provisions (objective element);

- it is apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage (subjective element).[304]

Therefore, both criteria have to be met in order to consider the relevant transaction to be an abusive practice. This was later on explicitly confirmed in the *Part Service*

[299] Case C-436/00 (*X and Y*), paragraph 44; see also case C-212/97 (*Centros*), paragraph 27.
[300] Case C- 9/02 (*Lasteyrie du Saillant*), paragraph 60.
[301] Case C-167/01 (*Inspire Art*), paragraphs 95, 96; case C-212/97 (*Centros*), paragraph 18; case 79/85 (*Segers*), paragraph 16.
[302] Case C-196/04 (*Cadbury Schweppes*), paragraph 36.
[303] Case C-196/04 (*Cadbury Schweppes*), paragraph 38.
[304] Case C-255/02 (*Halifax and Others*), paragraphs 74, 75, 86.

case.[305] It is important to note that, with respect to the second criterion, the Court held in the *Halifax* case that the prohibition of abuse is not relevant where the economic activity carried out may have some explanations other than the mere attainment of tax advantages.[306] In order to determine the real substance and significance of the transactions concerned, the national court *"(…) may take account of the purely artificial nature of those transactions and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden."*[307] This was basically confirmed in the *Part Service* decision, but the Court added that *"(…) those aspects being such as to demonstrate that the accrual of a tax advantage constitutes the principal aim pursued, notwithstanding the possible existence, in addition, of economic objectives arising from, for example, marketing, organisation or guarantee considerations."*[308] In my opinion, the second part of the latter sentence may lead to some confusion regarding the question whether an abusive practice exists despite the fact that the transactions follow economic objectives. In my opinion, it is important to see the statement of the ECJ in the context of the case: in *Part Service*, a structure was established to separate leasing income into different components in order to achieve, at least for part of the components, an exemption from VAT (otherwise the total amount of leasing income would have been subject to VAT). The separation of the components and the allocation to two different entities may have economic and other (non tax-related) reasons - and this was put forward by the taxpayer.[309] However, it seems that the structure has to be assessed in its totality and that the non-tax related reasons were of minor significance, compared to the loss of VAT for the Member State which was achieved by the structure. So, the *Part Service* case made it clear that it is not enough "to have some explanations other than the mere attainment of tax advantages", but the explanations have to be of some relative significance.

The conclusions derived from the case law of the ECJ in the field of indirect taxation are, in principle, of relevance for cases dealing with direct taxation as well.[310] In the

[305] Case C-425/06 (*Part Service*), paragraphs 42, 58. In *Part Service* it was also clarified - with respect to the second criterion - that the obtaining of a tax advantage has to be the *principal aim* but not necessarily the *sole aim* of the transaction (see paragraphs 44, 45). See with respect to the different terminology of the ECJ in this context also De Broe, Some Observations on the 2007 Communication from the Commission: 'The Application of Anti-Abuse Measures in the Area of Direct Taxation within the EU and in Relation to Third Countries', EC Tax Review 2008, page 142, footnote no. 3.
[306] Case C-255/02 (*Halifax and Others*), paragraph 75.
[307] Case C-255/02 (*Halifax and Others*), paragraph 81; see also case C-110/99 (*Emsland Stärke*), paragraph 58.
[308] Case C-425/06 (*Part Service*), paragraph 62.
[309] Case C-425/06 (*Part Service*), paragraph 19.
[310] See with respect to this question and the abuse of law concept in an EU context, *in alia*, Ruiz Almendral, Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?, Intertax 2005, page 562 et seq.; Vanistendael, *Halifax* and *Cadbury Schweppes*: One Single European Theory of Abuse in Tax Law?, EC Tax Review 2006, page 192 et seq.; Rousselle / Liebmann, The Doctrine of the Abuse of Community Law: The Sword of Damocles Hanging over the Head of EC Corporate Tax Law?, European Taxation 2006, page 559 et seq.; Vinther / Werlauff, Tax Motives Are Legal Motives - The Borderline between the Use and Abuse of the Freedom of Establishment with Reference to the *Cadbury Schweppes* Case, European Taxation 2006, page 383 et seq.; Merks, Tax Evasion, Tax Avoidance and Tax Planning, Intertax 2006, page 272 et seq.; Leclercq, Interacting Principles: The French Abuse of Law Concept and the EU Notion of Abusive Practices, Bulletin for International Taxation 2007, page 235 et seq.; De Broe, Some Observations on the 2007 Communication from the Commission: 'The Application of Anti-Abuse Measures in the Area of Direct Taxation within the EU and in Relation to Third Countries', EC Tax Review 2008, page 142; Innamorato, An Unwritten Anit-Abuse Principle in the Italian Tax System, European Taxation 2008, page 449 et seq.; Pistone, European Tax Law: *Quo Vadis*? in L. Hinnekens and P. Hinnekens (eds.), A Vision of Taxes Within and Outside European Borders: Festschrift in Honour of Prof. Dr. Frans Vanistendael, 2008, page 713 et seq.; Zalasinski, Some Basic Aspects of the Concept of Abuse in the Tax Case Law of the European Court of Justice, Intertax 2008, page 156

Cadbury Schweppes case, for example, the ECJ explicitly referred to the two-criteria approach described in the *Halifax* case.[311] However, it seems that a differentiation is nonetheless required between cases dealing with abusive structures in the field of indirect taxation and the question of abuse in the field of direct taxation. Pursuant to Innamorato, in order to define the subjective element, reference is made - in VAT cases - to the objective of the transaction instead of the intentions of the taxpayers and, in addition, the ECJ appears to give more weight to the objective element.[312] According to Zalasinski, the conditions are different from the factors of artificiality applicable in case of the basic freedoms. The system of VAT confers the entitlement to a direct financial transfer from the public sector upon individuals and, therefore, the abuse test includes the reference to the intention to obtain a tax advantage. In contrast thereto, the basic freedoms are not aimed at granting direct financial advantages to taxpayers.[313] Pursuant to Vanistendael, the important difference between *Halifax* and *Cadbury Schweppes* is the fact that in *Halifax* the ECJ still leaves some leeway to the national courts in VAT to decide whether the tax motive is 'essential' compared to some other non-tax explanations. This is not the case in *Cadbury Schweppes*. Here, the ECJ states categorically that when the cross-border economic reality of the transactions is established there can be no tax avoidance and the goal of achieving the tax advantage has no importance.[314] In my opinion, *Part Service* is, in general, in line with these findings: the tax motive was considered to be essential whereas the other non-tax related reasons were of minor significance (but apparently existent). For this reason, I do not think that the conclusions derived from *Halifax* and the subsequent cases *Part Service* and *Ampliscientifica* will have an immediate and major impact in the field of direct taxation.[315] I will come back to this question in chapter 8 when the concrete legislation will be examined.

4.2.10. Justifications for a Restriction on the Basic Freedoms

4.2.10.1. General Aspects

It is clear from the case law of the ECJ that any restriction on the basic freedoms is prohibited, even if it is of limited scope or minor importance.[316] Such a restriction on

et seq.; Prebble / Prebble, Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law, Bulletin for International Taxation 2008, page 151 et seq.; Schwarz, Abuse and EU Tax Law, Bulletin for International Taxation 2008, page 289 et seq.

[311] Case C-196/04 (*Cadbury Schweppes*), paragraph 64.

[312] Innamorato, An Unwritten Anit-Abuse Principle in the Italian Tax System, European Taxation 2008, page 449 et seq. (451). See in this respect also Pistone, European Tax Law: *Quo Vadis*? in L. Hinnekens and P. Hinnekens (eds.), A Vision of Taxes Within and Outside European Borders: Festschrift in Honour of Prof. Dr. Frans Vanistendael, 2008, page 713 et seq. (717).

[313] Zalasinski, Some Basic Aspects of the Concept of Abuse in the Tax Case Law of the European Court of Justice, Intertax 2008, page 156 et seq. (165). See with respect to the *Halifax* case also Brennan, Why the ECJ should not follow Advocate General Maduro's Opinion in *Halifax*, International VAT Monitor 2005, page 247 et seq.; Risdale, Abuse of Rights, Fiscal Neutrality and VAT, EC Tax Review 2005, page 82 et seq.

[314] Vanistendael, *Halifax* and *Cadbury Schweppes*: One Single European Theory of Abuse in Tax Law?, EC Tax Review 2006, page 192 et seq. (195).

[315] Case C-162/07 (*Ampliscientifica*), May 22, 2008. See in this respect also Innamorato who, in essence, concluded that the outcome of *Cadbury Schweppes* is still valid, despite the *Part Service* decision (Innamorato, An Unwritten Anti-Abuse Principle in the Italian Tax System, European Taxation 2008, page 449 et seq. (452).

[316] Case C-49/89 (*Corsica Ferries France*), ECR 1989 page 4441, paragraph 8; case C-34/98 (*Commission of the European Community v French Republic*), February 15, 2000, ECR 2000, page I-00995, paragraph 49: *"(t)he free movement of goods, persons, services and capital are fundamental Community provisions and any restriction, even minor, of that freedom is prohibited;"* case C-9/02 (*Hughes de Lasteyrie du Saillaint v Ministere de l'Economie, des Finances et de l'Industrie*), March 11, 2004, ECR 2004, paragraph 43: *"(...) a*

the basic freedoms may theoretically be justified by reasons which are stipulated in the TFEU itself. In addition to these "written" justifications there are justifications which are not expressly stipulated in the TFEU but which have to be taken into consideration as well. In fact, it seems that in the case law of the ECJ in the field of direct taxation the latter justifications play an even more important role than the written justifications. In *Dassonville* the ECJ concluded that a Member State may "*take measures"* but these measures "*should be reasonable*."[317] In the *Cassis de Dijon* decision the Court made it clear that *"(o)bstacles to movement within the Community resulting from disparities between the national laws (...) must be accepted in so far as those provisions may be recognised as being necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer."* [318] After the *Cassis de Dijon* decision it is clear that Member States may protect their domestic legislation under certain circumstances and based on "unwritten" justifications (the "Cassis doctrine" or the "rule of reason").[319] These justifications recognised under the rule of reason are called overriding reasons (or mandatory requirements) of public interest. However, such restrictive measures must be *appropriate* for the protection of the recognised public interest and *proportionate* in relation to the goal pursued.[320] This is not the case if there are equally effective measures which would be less restrictive.

4.2.10.2. Justifications Stipulated in the Treaty on the Functioning of the European Union

The justifications expressly stipulated in the TFEU, such as, for example, public policy, public security, or public health are usually irrelevant in the field of direct taxation.[321] However, Article 64 (1) and Article 65 (1) and (3) of the TFEU shall be referred to in this context.[322] Article 64 (1) of the TFEU allows Member States to retain measures which can result in a restriction on the free movement of capital to or from third countries involving direct investment - including in real estate - establishment, the provision of financial services or the admission of securities to capital markets.[323] This is only true, however, if the national measures already

restriction on freedom of establishment is prohibited by Article 52 of the Treaty even if of limited scope or minor importance;" case C-483/99 (*Commission of the European Communities v French Republic*), June 4, 2002, ECR 2002 page I-04781, paragraph 21: *"Those national rules, although applicable without distinction, create obstacles to the right of establishment of nationals of other Member States and to the free movement of capital within the Community, inasmuch as they are liable to impede, or render less attractive, the exercise of those freedoms."*

317 Case C 8-74 (*Procureur du Roi v Benoit and Gustave Dassonville*), July 11, 1974, ECR 1974 page 00837, paragraph 6.

318 Case 120/78 (*Rewe-Zentral AG v Bundesmonopolveraltung für Branntwein*), February 20, 1979, ECR 1979 page 00649, paragraph 8.

319 See in this respect Cordewener, Europäische Grundfreiheiten und nationales Steuerrecht, pages 60, 61.

320 Terra / Wattel, European Tax Law, 1997, page 22.

321 Article 45 (3) and Article 52 of the TFEU. See in this respect also Arginelli, The Discriminatory Taxation of Permanent Establishments by the Host State in the European Union: a Too Much Separate Entity Approach, Intertax 2007, page 82 et seq. (89); Englisch, The European Treaties' Implications for Direct Taxes, Intertax 2005, page 310 et seq. (326).

322 See with respect to a detailed analysis of Article 64 (1) of the TFEU: Smit, Capital Movements and Third Countries: The Significance of the Standstill-Clause ex-Article 57 (1) of the EC Treaty in the Field of Direct Taxation, EC Tax Review 2006, page 203 et seq.

323 Article 64 (1) of the TFEU.

existed on 31st of December 1993.[324] In other words, if the restrictive national measures existed on the aforementioned date, they can be applied without any further justification, e.g. under the rule of reason. The ECJ clarified that the national measures can even be adopted after 31st of December 1993. A provision which is, in substance, identical to the previous legislation ('substance criterion'), or limited to reducing or eliminating an obstacle to the exercise of EU rights and freedoms in the earlier legislation ('rollback criterion'), will be covered by the derogation. By contrast, legislation based on an approach which differs from that of the previous measures and establishes new procedures cannot be treated as legislation existing on 31st of December 1993.[325] Pursuant to Smit, the focus should be on the restrictive elements of the legislation (and not the legislation as a whole). Thus, if one or more restrictive elements are introduced, these elements cannot be regarded as existing restrictions, even if the legislation remains, in substance, identical to the previous legislation.[326] From my perspective, it is a logical approach to focus on the imposition of restrictive elements instead of the legislation as a whole. However, this means that Article 64 (1) of the TFEU does not lead to a "strict fossilisation" of the respective legislation.[327] Moreover, Article 65 (1) of the TFEU allows the Member States (i) to apply the relevant provisions of their tax laws which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested and (ii) to take all requisite measures to prevent infringements on national law and regulations.[328] This, again, is an important stipulation in the TFEU itself which, of course, can be of particular relevance for an investment in a company established in a third country. However, it is determined that the measures and procedures referred to in Article 65 (1) of the TFEU shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital.[329]

4.2.10.3. Justifications under the Rule of Reason

The existing case law in the field of direct taxation shows that the justifications which were accepted under the rule of reason are rather limited. Arguments of a purely budgetary or economic nature, for example, have never been accepted by the Court as an overriding reason of public interest.[330] In addition, not all of the justifications put forward by the Member States are of significance for the study. I will therefore concentrate on the examination of those arguments which came up in cases dealing with direct taxation and which can theoretically be of relevance in the context of this study. However, in order to avoid an overlapping with chapter 8 - where CFC legislation and European Union law will be examined - the *Cadbury Schweppes* case

[324] Article 64 (1) of the TFEU. In respect of restrictions existing under national law in Estonia and Hungary, the relevant date shall be 31 December 1999.
[325] See case C-302/97 (*Konle*), paragraph 53; C-446/04 (*Test Claimants in the FII Group Litigation*), paragraph 192; case C-157/05 (*Holböck*), paragraph 41.
[326] Smit, Capital Movements and Third Countries: The Significance of the Standstill-Clause ex-Article 57 (1) of the EC Treaty in the Field of Direct Taxation, EC Tax Review 2006, page 203 et seq. (209, 210).
[327] See with respect to the "strict fossilisation" also Schönfeld, The Cadbury Schweppes Case: Are the Days of the United Kingdom's CFC Legislation Numbered?, European Taxation 2004, page 441 et seq. (448).
[328] Article 65 (1) of the TFEU.
[329] Article 65 (3) of the TFEU.
[330] See inter alia case C-35/98 (*Verkooijen*), paragraph 48; case C-436/00 (*X and Y*), paragraph 50; case C-484/93 (*Svensson and Gustavsson*), paragraph 15; see also case C-288/89 (*Stichting Collectieve Antennevoorziening Gouda and Others v Commissariaat voor de Media*), July 25, 1991, ECR 1991, page I-4007, paragraph 11; case C-120/95 (*Decker v Caisse de Maladie des Employes Prives*), ECR 1998, page I-1831, paragraph 39; case C-158/96 (*Kohll v Union des Caisses de Maladie*), ECR 1998, page I-1931, paragraph 41.

(the first case dealing with CFC legislation) will be excluded from the examinations below and will only be discussed in chapter 8. However, the relatively large number of cases and the limited number of possible justifications should provide a general basis for the later verifications.

4.2.10.3.1. Justification Based on the Cohesion of the Tax System

The need to safeguard the cohesion of the applicable tax system is typically invoked by the Member States as a justification. It was once accepted by the Court in *Bachmann* [331] and the parallel *Commission v Belgium* case.[332] In the *Bachmann* case a link between the deductibility of insurance contributions and the liability to tax sums payable by the insurers existed under Belgian law. Pensions, annuities, capital sums or surrender values under life insurance contracts were exempt from tax if there was no deduction of contributions for tax purposes. On the other hand, the loss of revenue resulting from the possible deduction of contributions was offset by the subsequent taxation of the payments made by the insurers. In the underlying case, a German national employed in Belgium was refused to deduct contributions paid in Germany pursuant to sickness and invalidity insurance contracts and a life assurance contract concluded prior to his arrival in Belgium.[333] According to Belgian law only voluntary sickness and invalidity insurance contributions paid to a mutual insurance company recognised by Belgium and pension and life insurance contributions paid in Belgium were deductible from occupational income.[334] The cohesion of the Belgian system required the certainty to tax the benefits if the insurance premiums had been deducted, which was not the case if the benefits were paid abroad. The Court accepted the link between deduction and subsequent taxation as a condition which may be justified by the need to preserve the cohesion of the applicable tax system.[335] There are some important elements which can be derived from the existing case law and which can be separated:[336]

a.) The right to tax is waived under a double taxation convention

In the *Wielockx* decision [337] the consequences of double taxation conventions were added to the cohesion argument. With respect to the question of the tax deduction of pension reserves and the subsequent taxation of income from pensions the Court pointed out that *"(...) the effect of double-taxation conventions which (...) follow the OECD model is that the State taxes all pensions received by residents in its territory, whatever the State in which the contributions were paid, but, conversely, waives the right to tax pensions received abroad even if they derive from contributions paid in its territory which it treated as deductible. Fiscal cohesion has not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States. Since*

[331] Case C-204/90 (*Hanns-Martin Bachmann v Belgian State*), January 28, 1992, ECR 1992 page I-00249.
[332] Case C-300/90 (*Commission v Belgium*), ECR 1992, page I-00305.
[333] Case C-204/90 (*Bachmann*), paragraph 2.
[334] Case C-204/90 (*Bachmann*), paragraph 3.
[335] Case C-204/90 (*Bachmann*), paragraph 35.
[336] The justification based on the cohesion of the tax system was rejected in a number of cases. However, there are also cases where the justification was, in principle, accepted but did not pass the proportionality test (e.g. in case C-319/02 (*Manninen*), case C-418/07 (*Papillon*).
[337] Case C-80/94 (G.*H.E.J. Wielockx v Inspecteur der Directe Belastingen*), August 11, 1995, ECR 1995 page I-02493.

fiscal cohesion is secured by a bilateral convention concluded with another Member State, that principle may not be invoked to justify the refusal of a deduction such as that in issue." [338] This was subsequently confirmed in *X and Y.*[339] It is therefore clear that a Member State cannot rely on the cohesion argument if it gives away the cohesion at the individual taxpayer level in favour of the cohesion at the interstate level. [340] This was obviously not considered in the *Bachmann* case where the tax treaty between Belgium and Germany should theoretically lead to a similar outcome. The *Bachmann* decision is therefore limited to situations not covered by a tax treaty, or at least not covered by a tax treaty in a manner implying the waiving of cohesion at the individual taxpayer level by the two Member States involved.[341]

b.) The cohesion argument refers to more than one taxpayer and to separate taxes

Whereas in *Bachmann* and *Wielockx* only one taxpayer was concerned, the cohesion argument was in later cases also upheld by Member States in parent-subsidiary relations, i.e. where more than one taxpayer and separate taxes were involved. However, up to the *Manninen* decision the Court consistently ruled that the direct link between tax deduction and subsequent taxation which had to be maintained in order to preserve the cohesion of the tax system refers to one and the same taxpayer and one and the same tax and can therefore not be invoked if a group of companies is concerned. In the *ICI* case, the Court outlined that *"(...) there is no such direct link between the consortium relief granted for losses incurred by a resident subsidiary and the taxation of profits made by non-resident subsidiaries."* [342] The same was true in the *Verkooijen* case,[343] the *Baars* case,[344] the *Metallgesellschaft* case,[345] and the *Bosal Holding* case.[346] In the latter decision the Court pointed out that *"(u)nlike operating branches or establishments, parent companies and their subsidiaries are distinct legal persons, each being subject to a tax liability of its own, so that a direct link in the context of the same liability to tax is lacking and the coherence of the tax system cannot be relied upon."* [347]

However, the approach changed with the *Manninen* decision. The case related to two different taxpayers and two different taxes, namely the income taxation of the shareholder and the income taxation of the company in which the shareholder holds an interest. The ECJ did not immediately refuse the cohesion argument just because

[338] Case C-80/94 (*Wielockx*), paragraphs 24 and 25.
[339] Case C-436/00 (*X and Y v Riksskatteverket*), November 21, 2002, ECR 2002, page I-10829, paragraph 53.
[340] Terra / Wattel, European Tax Law, 1997, page 38
[341] Terra / Wattel, European Tax Law, 1997, pages 37 and 38.
[342] Case C-264/96 (*ICI*), paragraph 29.
[343] Case C-35/98 (*Verkooijen*), paragraph 57: "*In Bachmann and Commission v Belgium, a direct link existed, in the case of one and the same taxpayer (...)"*
[344] Case C-251/98 (*Baars*), paragraph 40: *"(...) which concerns two separate taxes levied on different taxpayers."*
[345] Joined cases C-397/98 and C-410/98 (*Metallgesellschaft Ltd. and Others, Hoechst AG and Hoechst (UK) Ltd. v Commissioners of Inland Revenue and HM Attorney General*), March 8, 2001, ECR 2001 page I-01727, paragraph 69: *"(…) there is no such direct link in the present cases between, on the one hand, the refusal to exempt subsidiaries in the United Kingdom of non-resident parent companies form payment of ACT under a group income election and, on the other, the fact that parent companies having their seat in another Member State and receiving dividends from their subsidiaries in the United Kingdom are not liable to corporation tax in the United Kingdom."*
[346] Case C-168/01 (*Bosal Holding*).
[347] Case C-168/01 (*Bosal Holding*), paragraph 32. See also the explanations in case C-471/04 (*Keller Holding*), paragraphs 39-43.

of the non-identity of taxpayers and taxes, but proceeded with additional verifications. The aim of the system in question was identified as the avoidance of double taxation[348] and there was an explicit link between the tax credit of the shareholder and the corporate income taxation of the company.[349] Finally, the Court rejected the arguments based on the cohesion of the tax system because of the fact that there can be measures which are less restrictive in order to achieve the aim pursued.[350] In order to understand the change in the approach followed by the Court, it is important to take into account the Opinion of the Advocate General Kokott who obviously follows a broader concept of fiscal cohesion.[351] The Advocate General outlined that *"(i)t is unclear whether the criteria 'one and the same taxpayer' and 'one and the same tax' are binding and must both be met, or whether they are only indicators - albeit strong ones - of the existence of a direct link between a tax advantage and disadvantage."*[352] The Advocate General suggested that one could also take the view *"(…) that the undertaking ultimately pays a kind of advance dividend tax on behalf of the shareholder, in so far as it deducts corporation tax on corporate earnings that are subsequently distributed as dividends. These considerations suggest that, exceptionally, a link justifying the tax cohesion argument may exist if a charge on one taxpayer is offset by a relief for another. The preconditions for this are that: the tax is levied, if not on the same taxpayer then at least on the same income or the same economic process, and the legal configuration of the system ensures that the advantage accrues to the one taxpayer only if the disadvantage to the other is real and in the same amount. (…) Hence, the argument based on cohesion of the tax system does not fail by reason of the fact that the present case relates to two taxpayers: the company and the recipient of the dividend*.[353] Apparently, the Court followed the position of the Advocate General, but did not go into detail in this respect. The deviation from the previous approach was confirmed in subsequent decisions, *inter alia* with respect to a parent-subsidiary relationship in the *Papillon* case.[354] The Court required that a direct link had to be established between *the tax advantage concerned* and the offsetting of that advantage by *a particular tax levy*.[355] However, the strict approach with the criteria 'one and the same taxpayer' and 'one and the same tax' does apparently not exist anymore.[356]

c.) The direct link between a tax relief and a subsequent taxation (advantage and disadvantage)

In the *Danner* case[357] the Finnish tax authorities refused to grant a full deduction for pension insurance contributions paid to pension insurance schemes operated by German insurance institutions.[358] By contrast, contributions paid to institutions in Finland were fully deductible. The Finnish (and Danish) Governments argued that the

[348] Case C-319/02 (*Manninen*), paragraph 48.
[349] Case C-319/02 (*Manninen*), paragraph 44.
[350] Case C-319/02 (*Manninen*), paragraphs 45 and 46.
[351] Opinion of the Advocate General Kokott (case C-319/02), March 18, 2004.
[352] Opinion of the Advocate General Kokott (case C-319/02), March 18, 2004, paragraphs 55 to 57.
[353] Opinion of the Advocate General Kokott (case C-319/02), March 18, 2004, paragraphs 60, 61, 65.
[354] Case C-418/07 (*Société Papillon v Ministère du Budget, des Comptes publics et de la Fonction publique)*, November 27, 2008. The case deals with the French tax integration regime.
[355] See, *inter alia*, case C-386/04 (*Stauffer*), paragraph 53; case C-471/04 (*Keller Holding*), paragraph 40; case C-433/06 (*Hollmann*), paragraph 60; case C-418/07 (*Papillon*), paragraph 44.
[356] See in this respect also Kemmeren, ECJ should not unbundle integrated tax systems!, EC Tax Review 2008, page 4 et seq. (5).
[357] Case C-136/00 (*Rolf Dieter Danner*), October 3, 2002, ECR 2002 page I-08147.
[358] Case C-136/00 (*Danner*), paragraph 2.

measure could be justified by the need to ensure the cohesion of the Finnish tax system since the system was based on the existence of a direct link between the deductibility of contributions and the liability to income tax of the pensions payable by insurers.[359] In its ruling the Court made it clear that a distinction has to be made to the situation in the *Bachmann* case. In the Belgian system the loss of revenue resulting from the deduction was offset by the taxation of the subsequent payments of the institutions, but - on the other hand - if the contributions had not been deducted, the subsequent payments would be consequently exempt from taxation.[360] However, under the Finnish system, the pensions payable by foreign institutions to Finnish residents were taxable, irrespective of whether the contributions were actually deducted or not.[361] If this is the case, the system does not provide a direct connection between the deductibility of contributions and the subsequent taxation of payments made by the institutions.[362] The requirement of a direct link between a tax advantage and the offsetting of that advantage by a particular tax levy was confirmed in a number of subsequent decisions - also with respect to a parent-subsidiary relationship.[363]

d.) The objective pursued by the tax legislation in question

In the *de Lasteyrie du Saillant* case[364] the ECJ started to examine the argument based on the need to safeguard the cohesion of a tax system in the light of the objective pursued by the respective legislation. The French legislation in question deals with the circumvention of the taxation of unrealised profits included in shareholdings by moving to another country. The Court held that the respective provision *"(…) is designed to prevent temporary transfers of tax residence outside France exclusively for tax reasons..*"[365] The provision in question *"(…) does not therefore appear to be aimed at ensuring generally that increases in value are to be taxed, in the case where a taxpayer transfers his tax residence outside France, in so far as the increases in value in question are acquired during the latter's stay on French territory.*"[366] Taking into account the aim of the provision, the justification based on fiscal coherence cannot be accepted.[367] The reasoning based on the objective pursued by the tax legislation in question was confirmed in subsequent decisions.[368]

With respect to the *Manninen* decision and the development of the cohesion doctrine Vanistendael stated that "*the justification was almost reduced to legal dust, from which a new principle of cohesion would arise*."[369] In summary, he concluded, based on the Opinion of the Advocate General Kokott, that the ECJ engaged in a movement of "*cautious relaxation*" of the respective criteria. This is, according to Vanistendael, a

[359] Case C-136/00 (*Danner*), paragraph 33.
[360] Case C-136/00 (*Danner)*, paragraph 36; see also case C-422/01 (*Skandia*), paragraph 33.
[361] Case C-136/00 (*Danner*), paragraph 38.
[362] Case C-136/00 (*Danner*), paragraph 37.
[363] See, *inter alia*, case C-418/07 (*Papillon*), paragraph 44.
[364] Case C-9/02 (*Hughes de Lasteyrie du Saillant v Ministère de l' Èconomie, des Finances et de I' Industrie)*, March 11, 2004, ECR 2004, page I-02409.
[365] Case C-9/02 (*de Lasteyrie du Saillant*), paragraph 64.
[366] Case C-9/02 (*de Lasteyrie du Saillant*), paragraph 65.
[367] Case C-9/02 (*de Lasteyrie du Saillant*), paragraph 67.
[368] See, *inter alia*, case C-319/02 (*Manninen*), paragraphs 43 to 48; case C-315/02 (*Lenz*), paragraphs 37 to 39.
[369] Vanistendael, Cohesion: The Phoenix Rises from his Ashes, EC Tax Review 2005, page 208 et seq. (208); see with respect to an overview of the coherence principle in the case law of the ECJ: Verdoner, The Coherence Principle under EC Tax Law, European Taxation 2009, page 274 et seq.

restatement of the direct link which puts more emphasis on the real effect of the tax rules and widens the scope in a way that it applies to all tax systems of all Member States across the whole Internal Market and is not just limited to the national territory of a single Member State.[370] In a more recent article to the *Papillon* decision it was Hahn who made a further separation with respect to the principle of cohesion.[371] In a number of cases, including *Bachmann*, the focus was on a *quantitative* and *systematic* link which might even partially be interpreted as an exception to the prohibition of the compensation of advantages and disadvantages.[372] However, pursuant to Hahn, some of the more recent decisions apparently focused more on the *functional* element.[373] In the latter case, the question whether the legislation is appropriate and proportionate plays a more important role than in the first-mentioned case. According to Hahn, this development might finally lead to a change in the concept of cohesion which makes this justification more difficult and complicated.[374] In my opinion, there is certainly the risk that the justification based on the cohesion of the tax system will be put forward to justify all types of restrictive measures and will become, as described by Hahn, the 'top hat of the magician out of which he can produce any desired or desirable animal'.[375]

4.2.10.3.2. Justification Based on the Loss of Tax Revenue and the Erosion of the Tax Base

A justification which is based on any kind of compensation for the loss of tax revenue and the erosion of the tax base is - similar to what was outlined above - an argument which is directed to safeguard the cohesion of the applicable tax system. However, it has to be pointed out in this respect that it is settled case law of the ECJ that *"(...) aims of a purely economic nature cannot constitute an overriding reason in the general interest justifying a restriction of a fundamental freedom guaranteed by the Treaty."* [376] This general statement is also of particular relevance for the question whether the loss of revenue and the erosion of the tax base can theoretically be justified at all. In the *ICI* case, the UK tax authorities made the application of a provision which allowed the offsetting of losses of a UK subsidiary with the profits of the parent holding company, *inter alia*, dependent on the fact that the majority of the subsidiaries are bodies corporate resident in the UK.[377] The UK Treasury argued that one of the objectives of this measure was to prevent a reduction in tax revenue

[370] Vanistendael, Cohesion: The Phoenix Rises from his Ashes, EC Tax Review 2005, page 208 et seq. (221, 222); see in this respect also Arginelli, The Discriminatory Taxation of Permanent Establishments by the Host State in the European Union: a Too Much Separate Entity Approach, Intertax 2007, page 82 et seq. (93).
[371] Hahn, Im Westen nichts Neues, Überlegungen zur Entscheidung des EuGH in der Rechtssache *Papillon*, Internationales Steuerrecht 2009, page 198 et seq. (201).
[372] Case C-204/90 (*Bachmann)*, case C-484/93 (*Svensson/Gustavsson*), paragraph 18; case C-264/96 (*ICI*), paragraph 29; case C-471/04 (*Keller*), paragraph 40; case C-157/07 (*Krankenheim Ruhesitz am Wannsee*), paragraph 42.
[373] Case C-9/02 (*Lasteyrie du Saillant*), paragraphs 65 to 67; case C-319/02 (*Manninen*), paragraphs 42, 43.
[374] Hahn, Im Westen nichts Neues, Überlegungen zur Entscheidung des EuGH in der Rechtssache *Papillon*, Internationales Steuerrecht 2009, page 198 et seq. (201).
[375] Hahn, Im Westen nichts Neues, Überlegungen zur Entscheidung des EuGH in der Rechtssache *Papillon*, Internationales Steuerrecht 2009, page 198 et seq. (201).
[376] Case C-35/98 (*Verkooijen*), paragraph 48; case C-436/00 (*X and Y*), paragraph 50; case C-484/93 (*Svensson and Gustavsson*), paragraph 15; see also case C-288/89 (*Stichting Collectieve Antennevoorziening Gouda and Others v Commissariaat voor de Media*), July 25, 1991, ECR 1991, page I-4007, paragraph 11; Case C-120/95 (*Decker v Caisse de Maladie des Employes Prives*), ECR 1998, page I-1831, paragraph 39; case C-158/96 (*Kohll v Union des Caisses de Maladie*), ECR 1998, page I-1931, paragraph 41.
[377] Case C-264/96 (*ICI)*, paragraph 7.

caused by the mere existence of non-resident subsidiaries, since the Inland Revenue could not tax profits made by subsidiaries located outside the UK in order to offset the revenue lost through the granting of relief on losses incurred by resident subsidiaries.[378] Similarly - and in addition to the cohesion argument outlined above - the UK Treasury tried to combine the offsetting of losses between UK subsidiaries and a UK parent company with the fact that a foreign subsidiary is not taxable in the UK. The ECJ, however, stated that *"(i)n answer to the argument that revenue lost through the granting of tax relief on losses incurred by resident subsidiaries cannot be offset by taxing the profits of non-resident subsidiaries, it must be pointed out that diminution of tax revenue occurring in this way is not one of the grounds listed in Article 56 of the Treaty and cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment that is, in principle, incompatible with Article 52 of the Treaty."* [379] In the following *Saint-Gobain* case[380] the German Government put forward similar arguments in order to justify the different treatment of a permanent establishment of a non-resident company in Germany compared to a resident subsidiary of such a non-resident parent company. One of the arguments was the need to prevent a reduction in tax revenue given the impossibility of the German tax authorities to compensate for the reduction in revenue brought about by the granting of the tax concessions in question by taxing dividends distributed by non-resident companies limited by shares operating permanent establishments in Germany.[381] In this case as well, the Court clearly rejected this argument. The need to prevent a reduction in tax revenue was - like in the ICI case - not accepted as one of the grounds listed in Article 63 of the TFEU or a matter of overriding general interest.[382] The Court confirmed its view in subsequent decisions.[383]

In the *Bosal Holding* case the Dutch Government and the Commission argued that the limitation of the deductibility of costs incurred in relation to the holding of subsidiary companies was justified by the objective of avoiding an erosion of the tax base going beyond a mere diminution in tax receipts.[384] Interestingly, the argument of the Dutch Government and the Commission was directed to differentiate between the *erosion of the tax base* and the *loss of tax revenue*. Obviously, the erosion of the tax base should be considered to have a greater impact than the loss of tax receipts. However, the Court did not accept the argument and ruled that *"(s)uch a justification does not differ in substance from that concerning the risk of diminution in tax revenue. In that respect, the case-law of the Court of Justice shows that such a justification does not appear amongst the grounds listed in Article 56 (1) of the EC Treaty (now, after amendment, Article 46 (1) EC) and does not constitute a matter of*

---

[378] Case C-264/96 (*ICI)*, paragraph 25.
[379] Case C-264/96 (*ICI*), paragraph 28; see also cases C-397/98 and C-410/98 (*Metallgesellschaft and Others)*, paragraph 59.
[380] Case C-307/97 (*Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v Finanzamt Aachen-Innenstadt)*, September 21, 1999, ECR 1999, page I-06161.
[381] Case C-307/97 (*Saint-Gobain*), paragraph 49.
[382] Case C-307/97 (*Saint-Gobain*), paragraph 50: *"It must be stated in response to that argument that a reduction of revenue due to the impossibility of partially compensating for the reduction in tax yield brought about by the grant to foreign companies having a permanent branch in Germany of the various tax concessions in question is not one of the grounds listed in Article 56 of the EC Treaty (...) and cannot be regarded as a matter of overriding general interest (...)."*
[383] For example in case C-136/00 (*Danner*), paragraph 56; case C-436/00 (*X and Y*), paragraph 50; case C-422/01 (*Skandia)*, paragraph 53; case C-315/02 (*Lenz*), paragraph 40; case C-319/02 (*Manninen*), paragraph 49; case C-9/02 (*Lasteyrie du Saillant*), paragraph 51; case C-446/03 (*Marks & Spencer*), paragraph 44.
[384] Case C-168/01 (*Bosal Holding*), paragraph 20.

overriding general interest which may be relied upon in order to justify a restriction on the freedom of establishment." [385] Overall, it is obvious from the case law of the ECJ that a justification which is merely based on the loss of tax revenue and the erosion of the tax base will not be accepted by the ECJ.

4.2.10.3.3. Justification Based on the General Compensation for Advantages

An additional argument put forward by the German Government in the *Saint-Gobain* case was that the refusal of certain tax concessions could be justified by the advantage which permanent establishments enjoy in comparison with resident subsidiaries regarding the transfer of profits to the parent company.[386] However, the Court rejected this argument in a similar way as it already did in the former *Commission v France* case[387] and stated that *"(...) it must be observed that the difference in tax treatment between resident companies and branches cannot, however, be justified by other advantages which branches enjoy in comparison with resident companies and which, according to the German Government, will compensate for the disadvantages (…).. Even if such advantages exist, they cannot justify breach of the obligation laid down in Article 52 of the Treaty (…)."* [388] The fact that the Court does not even question whether there is actually an advantage emphasises the non-acceptance of a general principle based on a compensation approach.[389]

4.2.10.3.4. Justification Based on a Different Taxation in Another Member State

The justification based on a different taxation in another Member State is not necessarily the same as the justification which is based on the loss of tax revenue, the erosion of the tax base or the compensation for advantages. A case which is of particular relevance in this respect is the *Eurowings* case.[390] The case dealt with provisions of the German Trade Tax Law according to which certain add-backs were required to determine the tax base for the trade tax on capital and earnings.[391] In essence, part of the leasing payments had to be added back to the tax base of the lessee (and assets had to be included in the trade capital) if the payments were not taken into account for the determination of the trade tax of the lessor. In other words, an add-back was not required if the leasing income was subject to trade income tax (and assets were included in the trade capital) of the lessor.[392] As a result, the leasing payments were partly added-back in situations where the lessor was established outside of Germany since he was not obliged to pay trade tax on the leasing income. In a purely domestic situation, such an adding-back was most often not required since the lessor was subject to trade tax on the receipts of the activities. In the underlying case, *Eurowings* leased an aircraft from an Irish company. Based on the respective provisions of the German Trade Tax Law, an add-back had to be made for the purpose of the determination of the trade income tax and the trade tax

[385] Case C-168/01 (*Bosal Holding*), paragraph 42.
[386] Case C-307/97 (*Saint-Gobain*), paragraph 51.
[387] Case C 270/83 (*Commission v France*), paragraph 21; see in this respect also case C-107/94 (*Asscher)*, paragraph 53.
[388] Case C-307/97 (*Saint-Gobain*), paragraph 53.
[389] See in this respect also Cordewener, Europäische Grundfreiheiten und nationales Steuerrecht, page 679.
[390] Case C-294/97 (*Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna*), October 26, 1999, ECR 1999 page I-07447.
[391] The trade tax on capital was abolished with effect as of January 1, 1998.
[392] Case C-294/97 (*Eurowings*), paragraphs 7 to 10.

on capital.[393] *Eurowings* lodged a complaint against the decision of the German tax authorities and the Lower Tax Court of Münster subsequently referred to the ECJ for a preliminary ruling. One of the questions was whether it was necessary to take into account the fact that the lessor, an Irish company, pays no tax comparable to the trade tax and enjoys "Shannon privileges" in the form of a 10 percent corporation tax.[394]

The ECJ concluded that the legislation contained tax rules which differed depending on whether the provider of the services was established in Germany or in another Member State and which were less favourable to German undertakings leasing goods from lessors established in other Member States.[395] In other words, the respective tax rules reserve a fiscal advantage for those undertakings which lease goods from lessors established in Germany whilst depriving those leasing from lessors established in another Member State of such an advantage.[396] Such a different treatment based on the place of establishment of the lessor is prohibited by the freedom to provide services.[397] With respect to a possible justification based on the need for coherency of the tax system the ECJ pointed out that *"(…) a merely indirect link between a fiscal advantage accorded to a taxable person, such as the absence in the case of German undertakings leasing from lessors established in Germany of the obligation to make the add-backs in question, and the unfavourable tax treatment of another taxable person, such as the liability of such lessors to pay trade tax, cannot be used to justify the fact that German undertakings are treated differently according to whether they lease from lessors established in Germany or from lessors in other Member States*."[398] Moreover, the ECJ went on to clarify that the *"(…) difference of treatment can also not be justified by the fact that the lessor established in another Member State is there subject to lower taxation. Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State. As the Commission rightly observed, such compensatory tax arrangements prejudice the very foundations of the single market."*[399] The different treatment is therefore prohibited and cannot be justified.[400] The judgment of the ECJ is especially important with respect to the subject of this study. The ECJ clearly rejected the argument which was based on the link between a favourable tax treatment of one taxpayer and an unfavourable tax treatment of another taxpayer. The existence (or non-existence) of a trade tax and the fact that the lessor is subject to trade tax (or not) cannot be used as a criterion for a differentiation. The Court rejected this argument because of the fact that the link was considered to be merely indirect. This is a consequent result, taking into consideration the case law outlined above. Of course, this is true in both directions: the trade tax burden of the service provider cannot be the relevant criterion for a favourable treatment of the recipient of the services and, in turn, the lack of trade tax,

[393] Case C-294/97 (*Eurowings*), paragraph 13.
[394] Case C-294/97 (*Eurowings)*, paragraph 21; Lower Court of Münster (Finanzgericht Münster), July 28, 1997, Az. 9 K 3151/96 G, EFG 1997 pages 1255, 1257.
[395] Case C-294/97 (*Eurowings)*, paragraphs 36 and 37.
[396] Case C-294/97 (*Eurowings*), paragraph 40.
[397] Case C-294/97 (*Eurowings)*, paragraph 40.
[398] Case C-294/97 (*Eurowings*), paragraph 42.
[399] Case C-294/97 (*Eurowings*), paragraphs 43 - 45. See in this respect also case C-364/01 (*Barbier*), paragraph 71.
[400] Case C-294/97 (*Eurowings)*, paragraph 46.

i.e. the tax advantage for the service provider cannot be the relevant criterion for an unfavourable treatment of the recipient of the services. However, the Court went even further and denied any compensatory taxation, independent from the existence and non-existence of a trade tax and irrespective of the reason for the lower taxation in the other Member State. In my opinion, this has to be understood as a general prohibition of any compensatory taxation. The Court made the importance of such a prohibition very clear by outlining that this would otherwise "(…) *prejudice the very foundations of the single market*."[401] It should therefore be clear that the lower taxation in Ireland, even though it was a privileged taxation in the form of a 10 percent corporation tax, cannot outweigh the existing restriction of the freedom to provide services. In his Opinion to the case Advocate General Mischo pointed out that *"(i)f differences in the direct taxation of undertakings could be "neutralised" by compensatory levies imposed by Member States on intra-Community movements of goods, services and capital, little would remain of those fundamental freedoms. Virtually all goods and services moving between Member States would be subject to one compensatory levy or another. Member States and undertakings must in principle accept differences in fiscal charges in the same way as differences in social charges or labour costs."* [402]

In the *Danner* case, one of the arguments put forward by the Danish Government to justify the restriction applied to the right to deduct insurance contributions was the need to *preserve the integrity of the tax base*. If insurance contributions paid to schemes run by foreign insurers were deductible, residents in Member States with high income taxes would have a very strong incentive to take out insurance with institutions established in Member States with low income taxes. That would result, according to the Danish Government, in ploys by persons seeking to benefit from the most favourable tax system and this would not be without consequences for Member States which finance high quality social services through tax revenue. In addition, the Member States have a legitimate interest in disallowing the fiscal advantage of the deductibility of insurance contributions if the savings encouraged by the deduction are accumulated abroad.[403] The Court made it clear that the *need to fill the fiscal vacuum* was not accepted as a justification for a national measure which restricted the freedom to provide services[404] and the *need to prevent the reduction of tax revenue* was not one of the grounds listed in Article 52 of the TFEU or a matter of overriding general interest.[405] In addition, the Court confirmed that any tax advantage from the low taxation in the Member State where the service provider is established cannot be used by another Member State to justify a less favourable treatment in tax matters.[406] Therefore, the freedom to provide services precludes a Member State's tax legislation from restricting or disallowing the deductibility for income tax purposes of contributions paid to pension providers in other Member States while allowing such

[401] Case C-294/97 (*Eurowings*), paragraph 45; see in this respect also Advocate General Mischo, Opinion of the Advocate General (Case C-294/97 - *Eurowings*), January 26, 1999, paragraph 59.
[402] Advocate General Mischo, Opinion of the Advocate General (case C 294/97 - *Eurowings*), paragraph 59; see in this respect case C-379/92 (*Criminal Proceedings against Matteo Peralta*), July 14, 1994, ECR 1994 page I-03453, paragraph 34. In the *Peralta* case the Court outlined that disparities between national laws governing, for example, labour costs, social security costs or the tax system have to be accepted and do not – as such – lead to a restriction of the basic freedoms; see also Cordewener, Europäische Grundfreiheiten und nationales Steuerrecht, page 701.
[403] Case C-136/00 (*Danner*), paragraph 53.
[404] Case C-136/00 (*Danner*), paragraph 55; case C-118/96 (*Safir*), paragraph 34.
[405] Case C-136/00 (*Danner*), paragraph 56; case C-307/97 (*Saint-Gobain*), paragraph 51.
[406] Case C-136/00 (*Danner*), paragraph 56; case C-294/97 (*Eurowings*), paragraph 44.

contributions to be deducted if they are paid to pension providers in the first-mentioned Member State.[407]

The conclusions drawn by the Court in *Eurowings* and *Danner* were also confirmed in subsequent decisions, e.g. in *Skandia*[408] and *Lenz*.[409] Overall, it seems to be settled case law that if the justification is based on the different taxation in another Member State and the argument comes close (or is even identical) to the justifications based on the loss of tax revenues, the erosion of the tax base or the general compensation for advantages, there seems to be no chance that the ECJ will accept such a position.

4.2.10.3.5. Justification Based on the Principle of Territoriality

Two of the early cases which dealt with the justification based on the principle of territoriality were *Futura* and *AMID.*[410] Both cases dealt with one single entity with a permanent establishment in another Member State. The *Futura* case concerned the taxation of non-residents whereas the *AMID* case concerned the taxation of residents. In both cases, the Court accepted the separation of taxable income derived by a legal entity and the allocation of that income to the respective Member States concerned according to international tax principles, namely the principle of territoriality. In the subsequent *Bosal* case, the principle of territoriality again played an important role. However, in contrast to *Futura* and *AMID* the principle was now put forward by the Dutch Government as an argument in a situation where different legal entities - and therefore different taxpayers - were involved.

The *Bosal* case dealt with a provision in the Dutch Corporation Tax Act which governed that no account had to be taken of gains acquired from a holding or of the costs relating to a holding, unless it was evident that such costs were indirectly instrumental in making profit that is taxable in the Netherlands.[411] Based on that legislation, the *Bosal Holding B.V.* - a company established in the Netherlands - was not allowed to deduct the interest expenses in connection with the financing of its holdings in companies established outside of the Netherlands in other Member States.[412] In contrast, the interest expenses in connection with the investment in subsidiary companies established in the Netherlands were deductible. In his Opinion to the *Bosal* case Advocate General Alber made it very clear that it is *"(...) impossible to deduce from the territoriality principle that the profits and losses accruing to different taxpayers can be offset against each other."* [413] In its decision, the Court simply concluded that *"(...) the application of the territoriality principle in Futura Participations and Singer concerned the taxation of a single company which carried on business in the Member State where it had its principal establishment and in other Member States from secondary establishments."* [414] Furthermore, the Court pointed

[407] Case C-136/00 (*Danner*), paragraph 57.
[408] Case C-422/01 (*Försäkringsaktiebolaget Skandia (publ) and Ola Ramstedt v Riksskatteverket*), June 26, 2003.
[409] Case C-315/02 (*Anneliese Lenz gegen Finanzlandesdirektion für Tirol*), July 15, 2004.
[410] Case C-250/95 (*Futura Participations SA and Singer v Administration des contributions*), May 15, 1997; case C-141/99 (*Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v Belgische Staat*), December 14, 2000.
[411] Article 13 (1) of the Netherlands Wet op de Vennootschapsbelasting ; case C-168/01 (*Bosal Holding*), paragraph 8.
[412] Case C-168/01 (*Bosal Holding*), paragraph 9.
[413] Opinion of the Advocate General Alber, September 24, 2002, paragraph 67.
[414] Case C-168/01 (*Bosal Holding*), paragraph 38.

out that the argument with respect to the differentiation between subsidiaries which make profits in the Netherlands and subsidiaries without such profits was irrelevant since the difference in tax treatment concerned only the parent companies in the Netherlands, and as regards the tax situation of the parent companies in relation to the profits of their subsidiaries "(…) *it must be noted that those profits are not taxable in the hands of those companies, whether the profits come from subsidiaries taxable in the Netherlands or from other subsidiaries*. *Moreover, in a case concerning the tax treatment of a subsidiary which varied in relation to the seat of the parent company, the Court has held that the difference in the tax treatment of parent companies depending on whether or not they are resident cannot justify denial of a tax advantage to subsidiaries, resident in the United Kingdom, of parent companies having their seat in another Member State where that advantage is available to subsidiaries, resident in the United Kingdom, of parent companies also resident in the United Kingdom, since all those subsidiaries are liable to mainstream corporation tax on their profits irrespective of the place of residence of their parent companies*." [415] From my perspective, the outcome of the *Bosal* case does not mean that the Court has given up the territoriality principle as a valid justification. In the *Futura* case it was a single legal entity which derived income from activities in two jurisdictions and had to bear costs which had to be allocated to these jurisdictions. In *Bosal*, there were separate legal entities involved, and it was already clear from the existing case law that the Court consistently treated parent companies and subsidiary companies independent from each other. Thus, the principle of territoriality can theoretically be a valid justification for a restriction on the basic freedoms. However, the *Bosal* case shows that the principle of territoriality which came up in earlier cases cannot simply be transferred to the relationship between two separate legal entities, i.e. it might be especially relevant in cases of cross-border investments through transparent partnerships or permanent establishments.

4.2.10.3.6. Justification Based on the Protection of a Balanced Allocation of the Power to Impose Taxes between Member States

Another justification which can be identified in the case law of the ECJ is the justification based on the protection of a balanced allocation of the power to impose taxes between Member States. In the *Marks & Spencer* case, the ECJ stated that *"(…) in tax matters profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system in order to protect a balanced allocation of the power to impose taxes between the different Member States concerned."*[416] Therefore, it might be necessary *"(…) to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect to both profits and losses."*[417] And *"(…) to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States (…)."*[418] The justification based on the balanced allocation of the power to impose taxes played a significant role in the

[415] Case C-168/01 (*Bosal Holding*), paragraphs 39, 40; see also the cases C-397/98 and C-410/98 (*Metallgesellschaft and Others*), paragraph 60.
[416] Case C-446/03 (*Marks & Spencer*), paragraph 43.
[417] Case C-446/03 (*Marks & Spencer*), paragraph 45.
[418] Case C-446/03 (*Marks & Spencer*), paragraph 46.

cases *Rewe Zentralfinanz*, *Oy AA*, *Lidl Belgium* and *X Holding* as well.[419] In these cases the ECJ confirmed, in principle, the approach followed in the *Marks & Spencer* decision. Moreover, it is clear now that this can be a justification which is not necessarily to be connected to another justification (or other justifications) - as was the case in the *Marks & Spencer* decision. In the *X Holding* case, a case dealing with the Dutch legislation on the formation of a single tax entity and the different treatment in case of non-resident subsidiaries, the ECJ considered the need to safeguard the allocation of the power to impose taxes between Member States clearly to be a valid and 'exclusive' justification which does not have to be accompanied by another justification.[420] In fact, this was already Gutmann's position after *Oy AA*. Pursuant to Gutmann, if the measure protects the balanced allocation of the power to impose taxes, this acknowledgment alone suffices as a justification.[421] Of course, the latter justification and the justification based on the prevention of tax avoidance may be affected simultaneously, but this is not necessarily the case.[422] I fully agree with the latter conclusion - which has now been finally confirmed by the case law of the ECJ. It has to be noted, however, that there are critical voices after the decision in *X Holding* which consider the justification based on the protection of the balanced allocation of the power to impose taxes to be interpreted so widely that it potentially covers a broad spectrum of revenue concerns - which would be contrary to the settled case law of the ECJ since the latter did not accept revenue concerns and the risk of tax base erosion to be an acceptable argument to justify a restriction on the basic freedoms.[423]

4.2.10.3.7. Justification Based on the Effectiveness of Fiscal Supervision

In the *Cassis de Dijon* case the Court pointed out that the effectiveness of fiscal supervision constituted an overriding reason of general interest capable of justifying a restriction on the free movement of goods.[424] This was later on confirmed for other basic freedoms in the *Futura* decision.[425] Therefore, the justification based on the effectiveness of fiscal supervision was put forward in a number of subsequent cases, but the Court consistently rejected that argument in respect of Member States for the following reasons: measures which provide a different treatment for the deduction of costs (or the deduction of contributions) occurred in connection with investments (or insurance contracts) in another Member State and which are more restrictive as compared to a purely domestic situation can generally not be justified based on the effectiveness of fiscal control. The reason is that Council Directive 77/799/EEC[426] concerning mutual assistance by the competent authorities of the Member States in

---

[419] Case C-347/04 (*Rewe Zentralfinanz*), paragraphs 41, 42; case C-231/05 (*Oy AA*), paragraphs 55, 56; case C-414/06 (*Lidl Belgium*), paragraphs 31 to 34; case C-337/08 (*X Holding*), paragraphs 33, 42.
[420] Case C-337/08 (*X Holding*), paragraphs 33, 42.
[421] Gutmann, Taxation of Groups of Companies: Lessons to be Drawn from *Oy AA*, Tax Planning International European Tax Services, February 2008.
[422] See in this respect the 'diagram one' shown in Gutmann, Taxation of Groups of Companies: Lessons to be Drawn from *Oy AA*, Tax Planning International European Tax Services, February 2008.
[423] See Thiel / Vascega, *X Holding*: Why Ulysses Should Stop Listening to the Siren, European Taxation 2010, page 334 et seq. (348). See in this regard also Weber, ECJ 25 February 2010, C-337/08, *X Holding*, Highlights & Insights on European Taxation, 1/2010, page 64 et seq.; Englisch, EuGH Entscheidung: Besteuerung der Gewinne bei der Muttergesellschaft unter Ausschluss gebietsfremder Tochtergesellschaften - Anmerkungen, Internationales Steuerrecht 2010, page 213 et seq. According to Englisch, the decision in *X Holding* leaves more questions open than it answers.
[424] Case 120/78 (*Cassis de Dijon*), paragraph 8.
[425] Case C-250/95 (*Futura*), paragraph 31; see also case C-254/97 (*Baxter and Others*), paragraph 18.
[426] Council Directive 77/799/EEC, December 19, 1977, OJ 1977 L 336, p. 15.

the field of direct taxation can be invoked by a Member State in order to obtain all the information enabling it to ascertain the correct amount of income tax. In addition, there is nothing to prevent the tax authorities concerned from requiring the taxpayer himself to produce the proof which they consider necessary to assess whether or not the deduction requested should be allowed.[427] In the *Lasteyrie du Saillant* case the Court referred, in addition to the Council Directive 77/799/EEC, to the double tax conventions concluded by France and the so-called “recovery assistance” clause in those conventions.[428] Hence, the effectiveness of fiscal supervision may be ensured by measures which are less restrictive and therefore the different tax treatment is generally not accepted by the Court as a justification.[429] Therefore, it seems that the justification based on the effectiveness of fiscal supervision is, as such, an acceptable justification, but does not usually pass the proportionality test. The situation may be different with respect to third countries. Here, the Council Directive 77/799/EEC is not applicable and, therefore, the contractual obligations - if any - do not correspond to those which are established in the European Union. It was explicitly stated in the *A* case that a Member State is allowed, in principle, to make a differentiation in this respect between Member States and third countries.[430] This was subsequently confirmed in the *Rimbaud* decision - a case dealing with the relationship between France and Liechtenstein.[431] The Council Directive 77/799/EEC does not apply between the competent authorities and there is a lack of any obligation on the tax authorities of Liechtenstein to lend assistance. In contrast to the *ELISA* case (which involved only Member States), the ECJ did not recognise under the latter circumstances that a ‘case-by-case assessment’, i.e. the possibility that the taxpayer produces the necessary evidence, can be considered a less restrictive measure than the national French legislation at issue. In such a legal environment, there is no possibility for the Member State involved to examine the correctness of the information provided by the taxpayer.[432] A very similar situation to the one in the *Rimbaud* case exists in the *Prunus* case.[433] Here, the relationship between France and the British Virgin Islands is in the focus of the case. Similar to Lichtenstein, there is no obligation of the British Virgin Islands to provide assistance in tax matters. Consistently, the Advocate General comes to the conclusion that the French authorities are unable to use the cooperation mechanisms provided for in the Council Directive 77/799/EEC but also, if they were to accept documentary evidence from the taxpayer, they would find it difficult to verify its truthfulness or lawfulness. In the absence of cooperation instruments of the kind concluded between the Member States, it is reasonable to accept a differentiation. [434]

[427] Case C-240/90 (*Bachmann*), paragraphs 18-20; case C-279/93 (*Schumacker)*, paragraph 45; Case C-55/98 (*Vestergaard*), paragraphs 25-28; Case C-80/94 (*Wielockx*), paragraph 26; case C-136/00 (*Danner*), paragraphs 49 and 50; case C-422/01 (*Skandia*), paragraphs 42 and 43; case C-451/05 (*ELISA*), paragraphs 95, 98.
[428] Case C-9/02 (*Lasteyrie du Saillant*), paragraphs 68, 69.
[429] Case C-136/00 (*Danner*), paragraph 51; case C-422/01 (*Skandia*), paragraph 44.
[430] Case C-101/05 (*Skatteverket v A*), December 18, 2007, paragraphs 60, 63. See in this respect also case C-540/07 (*Commission v Italy*), November 19, 2009, paragraph 69.
[431] Case C-72/09 (É*tablissements Rimbaud SA v Directeur général des impots, Directeur des services fiscaux d'Aix-en-Provence*), October 28, 2010.
[432] Case C-72/09 (*Rimbaud*), paragraphs 47 to 51.
[433] Case C-384/09 (*Prunus SARL v Directeur des services fiscaux*) - not yet decided; Opinion of the Advocate General Cruz Villalón, delivered on December 9, 2010.
[434] Opinion of the Advocate General Cruz Villalón, paragraphs 89 to 91.

4.2.10.3.8. Justification Based on the Aim of Preventing Tax Avoidance

The Court already had to deal with such an argument in the *Commission v France* case. The French *avoir fiscal* provisions discriminated against the freedom of establishment because they were only available to French resident corporations, including wholly owned subsidiaries of foreign corporations, and not to French branches of foreign corporations. In this case, the Court held that *"(...) the risk of tax avoidance cannot be relied upon in this context. Article 52 of the EEC Treaty does not permit any derogation from the fundamental principle of freedom of establishment on such a ground."* [435] The Court very clearly rejected the argument of the risk of tax avoidance and without the restriction "*in this context*" one could even have the impression that such an argument could not be upheld as a justification at all.[436]

The argument was again put forward by the United Kingdom Government in the *ICI* case. The Government argued that the legislation at issue was designed to reduce the risk of tax avoidance. The risk was described as a *"(...) possibility for members of a consortium to channel the charges of non-resident subsidiaries to a subsidiary resident in the United Kingdom and to have profits accrue to non-resident subsidiaries. The purpose of the legislation at issue is therefore to prevent the creation of foreign subsidiaries from being used as a means of depriving the United Kingdom Treasury of taxable revenues."* [437] This, of course, was a very general argument and it supposed that the group companies shifted charges (and therefore also taxable profits) from one subsidiary to another or from a subsidiary to the parent company and vice versa. However, this can theoretically always be the case if a company or a group of companies invests abroad. It is even not only restricted to a foreign investment by way of establishing a subsidiary but can be equally relevant - at least to a certain extent - if a permanent establishment is created in another Member State. Thus, in its response to that argument the Court clearly outlined that *"(...) the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment."* [438] This was confirmed in the *X and Y* decision.[439] The formula used in the *ICI* case with respect to subsidiaries in other Member States was subsequently completed in *Lankhorst-Hohorst* with respect to parent companies in other Member States. The Court concluded that the German thin-capitalisation rule[440] *"(...) applies generally to any situation in which the parent company has its seat, for whatever reason, outside the Federal Republic of Germany. Such a situation does not, of itself, entail a risk of tax evasion, since such a company will in any event be subject to the tax legislation*

[435] Case C-270/83 (*Commission v France*), paragraph 25.
[436] Pursuant to Terra / Wattel *"(o)ne would have expected that under a rule of reason approach the French argument of prevention of abuse would at least in abstracto have been accepted. The Court's firm rejection of all of France's arguments and justifications is probably explained by the fact that in the case presented there was no risk of abuse whatsoever*" (Terra / Wattel, European Tax Law, 1997, page 41).
[437] Case C-264/96 (*ICI*), paragraph 25.
[438] Case C-264/96 (*ICI)*, paragraph 26.
[439] Case C-436/00 (*X and Y*), paragraphs 61 and 62.
[440] Section 8 a of the German Corporate Income Tax Act.

of the State in which it is established." [441] It was even confirmed by the national court itself that there was no abuse, since the loan was made "to prevent financial disaster" and to reduce the burden of loan interest from banking commitments.[442] It was therefore obvious in this particular case that the rule applied to a situation which was by no means "wholly artificial" but rather triggered by an economic and financial necessity. Based on the aforementioned case law, an anti-avoidance provision can only be accepted to be proportionate if it is specifically designed to target purely artificial schemes. Any general rule automatically excluding certain categories of operations would not fulfil the principle of proportionality. This was subsequently confirmed in a number of cases, such as the *Cadbury Schweppes* case, the *Test Claimants in the Thin Cap Group Litigation* case and the *Lammers & Van Cleeff* case.[443]

In the *Leur-Bloem* case and the *Kofoed* case the Court had to deal with the anti-abuse provision of the Merger Directive.[444] According to Article 11 (1) (a) of the Merger Directive a Member State may refuse to apply or withdraw the benefit of the Merger Directive if the transaction has as its principal objective or as one of its principal objectives tax evasion or tax avoidance. The Court held in *Leur-Bloem* that *"(...) in order to determine whether the planned operation has such an objective, the competent national authorities cannot confine themselves to applying predetermined general criteria but must subject each particular case to a general examination*."[445] Furthermore, *"(...) the laying down of a general rule automatically excluding certain categories of operations from the tax advantage (...) whether or not there is actually tax evasion or tax avoidance, would go further than is necessary for preventing such tax evasion or tax avoidance and would undermine the aim pursued by the Directive."*[446] In the *Kofoed* case the Court made it clear that Article 11 (1) (a) of the Merger Directive reflects the general EU law principle that the abuse of rights is prohibited.[447] It is clear, therefore, that the conclusions of the Court are equally relevant for both primary and secondary EU law.[448]

The case law outlined above shows, *inter alia*, that a differentiation has to be made between a justification which is based on the mere *risk of tax avoidance* and a justification which is based on the prevention of *tax avoidance*. The mere *risk* of tax avoidance seems to be an insufficient justification whereas the Court, in principle, accepted that the prevention of tax avoidance can be an acceptable justification. Furthermore, one might take the position that the necessity that the national measures have to be 'specifically designed to target wholly artificial arrangements' has been somehow mitigated in the *Oy AA* case.[449] In this case, the Court considered the national legislation in question to be proportionate despite the fact that the legislation was not specifically designed to exclude purely artificial

[441] Case C-324/00 (*Lankhorst-Hohorst*), paragraph 37; see also Case C-264/96 (*ICI*), paragraph 26.
[442] Opinion of the Advocate General Mischo, September 26, 2002, paragraph 92.
[443] Case C-196/04 (*Cadbury Schweppes*), paragraph 75; case C-524/04 (*Test Claimants in the Thin Cap Group Litigation*), paragraphs 72 to 74; case C-105/07 (*Lammers & Van Cleeff*), paragraphs 26 to 28, 32.
[444] Council Directive 90/434/EEC, dated July 23, 1990 (Merger Directive).
[445] Case C-28/95 (*Leur-Bloem*), paragraph 41.
[446] Case C-28/95 (*Leur-Bloem*), paragraph 44.
[447] Case C-321/05 (*Kofoed*), paragraph 38.
[448] See with respect to the free movement of capital and the reference to the *Leur-Bloem* decision case C-478/98 (*Commission v Belgium*), paragraph 45.
[449] Case C-231/05 (*Oy AA*), July 18, 2007.

arrangements from the tax advantage it confers.[450] In other words, the Finnish legislation in the *Oy AA* case was proportionate even though it may (also) target intra-group financial transfers which are not purely artificial. However, it is important to note that in *Oy AA* the safeguarding of the balanced allocation of the power to impose taxes *and* the prevention of tax avoidance were considered to be linked and accepted as a valid justification. I agree with Thömmes that - given the massive impact which the national measure might have in a cross-border situation - it would have been enough to rely on the balanced allocation of the power to impose taxes and unnecessary to create a link to the prevention of tax avoidance.[451] In contrast to *Marks & Spencer*, the case did not deal with the utilisation of losses, but with the possibility of transferring profits from one entity to another entity. In a cross border situation, such a possibility would jeopardize the basic principle of territoriality.[452] For this reason, I doubt that the ECJ really changed its position with respect to the necessity of 'specifically designed' measures in cases where only the prevention of tax avoidance is of relevance and *not* an additional justification. In my opinion, it would hardly be understandable to give up the necessity of 'specifically designed' measures in case of the (mere) prevention of tax avoidance - given the fact that this is settled case law and that the least proportionate measure has to be applied. Gutmann suggested that the ECJ should re-establish the distinction and - for measures aimed at preventing tax evasion - the requirements should be specific and apply concretely.[453] Essentially, the above conclusions are supported by the decision in *X Holding* where the ECJ considered the need to safeguard the allocation of the power to impose taxes between Member States to be a valid and 'exclusive' justification which does not have to be accompanied by another justification.[454]

4.2.10.3.9. Justification Based on Administrative Inconvenience

It is settled case law of the ECJ that administrative inconvenience is not capable of justifying an infringement of the basic freedoms.[455] For example, in the *Manninen* case, which deals with the different treatment of dividends received from domestic companies and foreign companies, the ECJ made clear that possible difficulties in the determination of the foreign tax actually paid cannot, in any event, justify an obstacle to the free movement of capital.[456] However, the more recent case law shows that the Court can be willing to accept a different treatment between residents and non-residents which is essentially linked to administrative inconvenience. In the *Truck Center* case[457] the Court had to deal with the question of a different treatment of interest payments made between companies resident in Belgium and interest payments made from a company resident in Belgium to a company resident in

[450] Case C-231/05 (*Oy AA*), paragraph 63.
[451] Thömmes considered this to be 'the only weakness' of the decision (see Thömmes, Kein Anspruch auf grenzüberschreitende Übertragung von Gewinnen innerhalb eines europäischen Konzerns, Internationale Wirtschafts-Briefe 2007, Fach 11A, page 1151 et seq. (1153). See with respect to the possible impact of the decision also Helminen, The Esab Case (C-231/05) and the Future of Group Taxation Regimes in EU, Intertax 2005, page 595 et seq. (602).
[452] See in this respect also Thömmes, Besinnung auf das Territorialitätsprinzip, Internationale Wirtschafts-Briefe 2006, Fach 11A, page 1071 et seq. (1073).
[453] Gutmann, Taxation of Groups of Companies: Lessons to be Drawn from *Oy AA*, Tax Planning International European Tax Services, February 2008.
[454] See in this regard also 4.2.10.3.6.
[455] See, inter alia, case C-334/02 (*Commission v France*), paragraphs 29 and 30; case C-315/02 (*Lenz*), paragraph 48; case C-319/02 (*Manninen*), paragraph 54.
[456] Case C-319/02 (*Manninen*), paragraph 54.
[457] Case C-282/07 (*Etat belge - SPF Finances v Truck Center SA*), December 22, 2008.

Luxembourg. In the first-mentioned situation there was no deduction of withholding tax at source whereas in the second-mentioned situation there was a deduction of withholding tax at source of 15 percent.[458] In essence, the Court accepted the difference in treatment, despite the fact that, at that time, the Benelux Convention provided for mutual administrative assistance in the recovery of tax claims.[459] The Court outlined that the resident recipient companies are directly subject to the supervision of the Belgian authorities, which is not the case with regard to non-resident companies inasmuch as, in their case, recovery of the tax requires the assistance of the tax authorities of the other Member State.[460] Thus, the Court seems to be more open now for arguments which are linked to administrative inconvenience.[461] According to Lang, as far as proportionality is concerned, the Court does not seem to require the Member States to impose only the least restrictive measure.[462]

4.2.10.4. Justifications and the Investment in Non-Member States

It is clear from the case law of the ECJ that a justification for a restriction on the free movement of capital may be seen differently depending upon whether the investment is made in a Member State or in a non-member state. In the *Test Claimants in the FII Group Litigation* decision and the *A* decision the ECJ held that it may be the case that a Member State will be able to demonstrate that a restriction on the free movement of capital to or from third countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States.[463] The same conclusions can be drawn from the *Rimbaud* decision and the Opinion of the Advocate General in the *Prunus* case.[464] Apparently, the movement of capital to or from third countries takes place in a different legal context from that which occurs within the EU (e.g. with respect to the application of the Council Directive 77/799/EEC).[465] However, it should not be overlooked that a Member State may have concluded double tax conventions and / or other agreements with third countries which may result in legal obligations which are comparable to those which are existent in the EU. In the latter case, it may be difficult for a Member State to demonstrate that a justification is to be "weighted" differently. On the other hand, if no (comparable) legal obligations are existent, e.g. in relation to a tax haven investment, it is obvious that a restriction on the free

[458] Case C-282/07 (*Truck Center*), paragraph 21. See with respect to a different treatment with respect to the taxation at source also case C-290/04 (*FKP Scorpio Konzertproduktionen GmbH v Finanzamt Hamburg-Eimsbüttel*), October 3, 2006, paragraphs 33 to 35.
[459] See in this respect the Opinion of Advocate General Kokott, September 18, 2008, paragraph 42.
[460] Case C-282/07 (*Truck Center*), paragraph 48.
[461] See with respect to the Opinion of the Advocate General regarding the *Truck Center* case also De Broe, Are we Heading towards an Internal Market without Dividend Withholding Tax but with Interest and Royalty Withholding Tax? Some Observations on Advocate General's Kokott Opinion in *Truck Center*, EC Tax Review 2009, page 2, 3; see with respect to the decision of the ECJ also De Broe / Bammens, Belgian Withholding Tax on Interest Payments to Non-resident Companies Does Not Violate EC Law: A Critical Look at the ECJ's Judgment in *Truck Center*, EC Tax Review 2009, page 131 et seq.; KPMG's EU Tax Centre, ECJ *Truck Center* case (C-282/07) - Decision, Tax Planning International European Tax Service, January 23, 2009.
[462] Lang, Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions, EC Tax Review 2009, page 98 et seq. (112).
[463] Case C-446/04 (*Test Claimants in the FII Group Litigation*), paragraph 171; case C-101/05 (*A*), paragraph 37. See with respect to the justifications in a third country context and the analysis of the two cases: Panayi, The Fundamental Freedoms and Third Countries: Recent Perspectives, European Taxation, 2008, page 571 et seq.
[464] Case C-72/09 (*Rimbaud*), paragraphs 47 to 51; Opinion of the Advocate General Cruz Villalón, (case C-384/09 (*Prunus*)), paragraphs 89 to 91.
[465] See in this respect also case C-101/05 (*A*), paragraph 36.

movement of capital can be justified, in this context, which would not be justified in case of an intra-EU investment. In other words, the justifications for a restriction on the free movement of capital have to be evaluated very carefully not only with respect to the question whether the investment is related to a Member State or a third country, but also with respect to the legal context in case of a third country investment. According to Cordewener, Kofler and Schindler, a differentiation between third countries might be considered, depending upon whether a tax treaty is concluded which provides for the exchange of information or not.[466] The decision in the *Commission v. Netherlands* case shows that, for example, an argumentation which is (just) based on the fact that Council Directive 77/799/EEC is not applicable in case of non-member states (here Iceland and Norway) cannot be accepted as a kind of 'knockout argument'.[467] In the latter case, the Commission made the point that even if it were more difficult to obtain compliance with obligations of international law than on the basis of EU law and the EU framework, it does not mean that the international conventions are irrelevant when answering the question whether the specific measure is proportionate to the objective pursued.[468] The ECJ did not give, in my opinion, a crystal clear answer, but pointed out that it could not be accepted that the Dutch legislation stipulated higher holding thresholds for Iceland and Norway in order to benefit from the exemption of dividend taxation at source in the Netherlands.[469] The higher holding thresholds bear no relation to the conditions otherwise required from all companies in order to be entitled to the exemption, e.g. a certain legal form, subject to tax on profits and the need to be the final beneficiary of the dividends paid.[470] It is accepted by the Court that the Dutch tax authorities must be in a position to verify compliance, but there is no evidence that a lower holding threshold has any impact on the risk that the competent authorities might be given erroneous information, particularly as regards the tax treatment in Iceland and Norway.[471] In my opinion, the ECJ (indirectly) accepts the fact that there can be an information exchange on a bilateral basis which deviates from the one existent within the EU on the basis of the Council Directive 77/799/EEC but which may have the same effect. This was subsequently confirmed in the *Commission v. Italy* case.[472] Here, the ECJ explicitly stated that the framework of cooperation on the basis of Council Directive 77/799/EEC did not exist between a Member State and a non-member state *"(…) when the latter has not entered into any undertaking of mutual assistance."*[473] In other words, if a cooperation is bilaterally concluded between a Member State and a non-member state, this may have the same effect as the cooperation on the basis of the latter Council Directive.[474] In the *Commission v. Italy* case no such mutual assistance was concluded with Liechtenstein, Iceland and Norway and, therefore, the Italian legislation was justified by an overriding reason in the public interest concerning the fight against tax evasion.[475]

[466] Cordewener / Kofler / Schindler, Free Movement of Capital, Third Country Relationships and National Tax Law: An Emerging Issue before the ECJ, European Taxation 2007, page 107 et seq. (116). See in this respect also Pistone, Ups and Downs in the Case Law of the European Court of Justice and the Swinging Pendulum of Direct Taxation, Intertax 2008, page 146 et seq. (151).
[467] Case C-521/07 (*Commission of the European Communities v. Kingdom of the Netherlands*), June 11, 2009.
[468] Case C-521/07 (*Commission v. Netherlands*), paragraph 30.
[469] Case C-521/07 (*Commission v. Netherlands*), paragraph 47.
[470] Case C-521/07 (*Commission v. Netherlands*), paragraph 48.
[471] Case C-521/07 (*Commission v. Netherlands*), paragraphs 48, 49.
[472] Case C-540/07 (*Commission of the European Communities v. Italian Republic*), November 19, 2009.
[473] Case C-540/07 (*Commission v. Italy*), paragraph 70.
[474] See in this respect also Simader, Withholding Taxes and the Effectiveness of Fiscal Supervision and Tax Collection, European Taxation 2010, page 115 et seq. (119).
[475] Case C-540/07 (*Commission v. Italy*), paragraphs 71, 72.

4.2.10.5. The Principle of Proportionality

I will not go into detail of the principle of proportionality since it will be part of the later verifications. However, it has to be kept in mind that the restrictive measures have to be appropriate for the protection of the recognised public interest and proportionate in relation to the goal pursued.[476] The proportionality principle can thus be considered a - generally recognised - fundamental principle of unwritten primary law which is inherent in the system of the TFEU.[477] Moreover, it plays a permanent and important role in the case law of the ECJ.[478] Therefore, the restrictive measures applied by the Member States not only have to pass the verification of the ECJ related to the possible justifications but also the test of proportionality. That means, even if the ECJ accepts one of the arguments put forward by the Member States as a justification for a restriction of the basic freedoms, the ECJ must be convinced that the measure does not go beyond what is necessary to achieve the aim of the provision and that there is no measure which is less burdensome.[479] The principle of proportionality is relevant for both investments in another Member State and investments in a third country. In other words, also in case of an investment in a third country, which may be covered by the free movement of capital, it is the least restrictive measure which has to be applied. Thus, despite the differentiation which might be required with respect to the justification for a restriction on the free movement of capital (see above), there is still the requirement to pass the test of proportionality.

4.2.11. Conclusions Regarding the Justifications for a Restriction on the Basic Freedoms

In the context of this study, the justifications which are explicitly stipulated in the TFEU seem to be of less importance compared to the justifications under the rule of reason. However, Article 64 (1) of the TFEU ('standstill clause') and Article 65 (1) and (3) of the TFEU can be of particular relevance with respect to the free movement of capital. With respect to the "unwritten" justifications under the rule of reason the following justifications were identified and examined in more detail:

- justification based on the cohesion of the tax system;
- justification based on the loss of tax revenue and the erosion of the tax base;

[476] Terra / Wattel, European Tax Law, page 22.
[477] See the references in Cordewener / Dahlberg / Pistone / Reimer / Romano, The Tax Treatment of Foreign Losses: *Ritter, M&S*, and the Way Ahead (Part Two), European Taxation 2004, page 218 et seq. (222). Pursuant to Cordewener / Dahlberg / Pistone / Reimer / Romano, the full-fledged application of the principle of proportionality comes down to a three-prong test: (1) suitability (is a certain national measure suitable to achieve or at least promote the alleged aim of a certain legitimate national interest?); (2) necessity (is there another national measure available that is equally effective in promoting the aim, but which is less burdensome for the addressee?); and (3) adequacy (proportionality *stricto sensu*: does the national measure, even though there is no other effective means, have an excessive impact on the addressee's own interests?) (see Cordewener / Dahlberg / Pistone / Reimer / Romano, page 223).
[478] See Cordewener, Europäische Grundfreiheiten und nationales Steuerrecht, page 71; Emiliou, The Principle of Proportionality in European Law, page 134. According to Emiliou, the principle of proportionality came up in more than 500 cases before the ECJ until the end of 1994.
[479] However, see the criticism in Lang, Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions, EC Tax Review 2009, page 98 et seq. (112, 113). Pursuant to Lang, it seems that the ECJ does not require the Member States to impose only the least restrictive measure. However, Lang clearly proposes that the ECJ applies the least restrictive measure.

- justification based on the general compensation for advantages;
- justification based on a different taxation in another Member State;
- justification based on the principle of territoriality;
- justification based on the protection of a balanced allocation of the power to impose taxes between Member States;
- justification based on the effectiveness of fiscal supervision;
- justification based on the aim of preventing tax avoidance;
- justification based on administrative inconvenience.

The examination shows that there are limited possibilities for the Member States to justify restrictions on the aforementioned basic freedoms. Some justifications have never been accepted, especially those which were merely based on budgetary or economic reasons, including justifications based on the erosion of the tax base and the loss of tax revenue. The justifications based on a general compensation for advantages and administrative inconvenience were rejected by the ECJ in earlier cases. However, from the more recent case law one might have the impression that the ECJ is more open now for arguments which are linked to administrative inconvenience. A justification based on a different taxation in another Member State must be seen in the context of the respective national legislation. If it comes close (or is even identical) to the argument based on the erosion of the tax base, the loss of tax revenue or the general compensation for advantages, it cannot be accepted as a valid justification. The principle of territoriality was accepted by the ECJ and might play a role in future decisions as well. The same is true for a justification based on the protection of a balanced allocation of the power to impose taxes between Member States. Other justifications, like the cohesion of the tax system, the effectiveness of fiscal supervision or the aim of preventing tax avoidance, can be acceptable under certain - very limited - circumstances. The reason is that restrictive measures applied by the Member States have to be appropriate for the protection of the recognised public interest and proportionate to the aim pursued. They must not go beyond what is necessary to achieve the aim of the provision. Thus, Member States are required to apply those measures which are the less restrictive to achieve the aim pursued.

4.3. Secondary European Union Law

The secondary EU law in the field of direct taxation which may be of particular importance for the further development of an internal market and the cross-border investments of multinational enterprises is certainly the Parent-Subsidiary Directive,[480] the Merger Directive,[481] the (proposed) Loss Compensation Directive[482] and the Interest and Royalties Directive.[483] However, in the context of this study it is,

[480] Council Directive 90/435/EEC, dated July 23, 1990 (Parent-Subsidiary Directive).
[481] Council Directive 90/434/EEC, dated July 23, 1990 (Merger Directive).
[482] COM (90) 595 final, submitted by the Commission on December 6, 1990 (Loss Compensation Directive).
[483] Council Directive 2003/49/EC, dated June 3, 2003 (Interest and Royalty Directive).

in particular, the Parent-Subsidiary Directive which can be of interest and which should therefore be examined in some more detail in the following and - with respect to CFC legislation - in chapter 8. Regarding the Interest and Royalty Directive, I will concentrate my comments on the impact in CFC cases, i.e. it will only be outlined in chapter 8. In my opinion, the general aspects of the latter Directive are of no particular importance for the purpose of this study.

4.3.1. The Parent-Subsidiary Directive

According to the preamble of the Parent-Subsidiary Directive the purpose of the latter is, *inter alia*, *"(...) to create within the Community conditions analogous to those of an internal market and in order thus to ensure the establishment and effective functioning of the common market*" and parent-subsidiary operations *"(...) ought not to be hampered by restrictions, disadvantages or distortions arising in particular form the tax provisions of the Member States*." It is therefore required *"(...) to introduce (...) tax rules which are neutral from the point of view of competition, in order to allow enterprises (...) to improve their competitive strength at the international level*." In order to achieve this purpose, the Parent-Subsidiary Directive stipulates that the Member State of the parent company which receives profit distributions from subsidiary companies established in another Member State should either refrain from taxing such profits or should tax such profits while providing a tax credit for the taxes imposed in the other Member State.[484] In other words, the Member State should follow the exemption method or the credit method for the avoidance of double taxation of dividend payments. The credit method itself is determined as an ordinary tax credit system which should be limited to the amount of domestic taxation. It is further stipulated that *"(...) each Member State shall retain the option of providing that any charges relating to the holding and any losses resulting from the distribution of the profits of the subsidiary may not be deducted from the taxable profits or the parent company. Where the management costs relating to the holding in such a case are fixed as a flat rate, the fixed amount may not exceed 5% of the profits distributed by the subsidiary*."[485] In addition to the clarification of the treatment of dividends in the state of the parent company, it is further determined that the Member State of the subsidiary company which distributes the profits should refrain - under certain circumstances - from deducting a withholding tax. In general, this should be the case if the parent company holds a minimum of 25 percent of the capital of the subsidiary company.[486] It should further be noted that the Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse.[487]

The question arises what has to be considered a "*distribution of profits*" in the sense of the Directive. Article 1 (1) of the Parent-Subsidiary Directive solely states that each Member State shall apply this Directive "*to distributions of profits received by companies of that State which come from their subsidiaries of other Member States*" and "*to distributions of profits by companies of that State to companies of other Member States of which they are subsidiaries*." The lack of a general definition of

[484] Article 4 (1) of the Parent-Subsidiary Directive.
[485] Article 4 (2) of the Parent-Subsidiary Directive.
[486] Article 5 (1) of the Parent-Subsidiary Directive. The percentage was reduced to 10 percent in the amended version of the Parent-Subsidiary Directive - after a transition period (Council Directive 2003/123/EC, dated December 22, 2003).
[487] Article 1 (2) of the Parent-Subsidiary Directive.

"*distribution of profits*" in the Directive leaves some room for interpretation. With respect to the Parent-Subsidiary Directive the Court stated in the *Athinaiki Zythopoiia* case [488] that "*(…) the nature of a tax, duty or charge must be determined by the Court, under Community law, according to the objective characteristics by which it is levied, irrespective of its classification under national law.*"[489] Therefore, it is an autonomous classification which has to be made by the Court and which is, in principle, unconnected to the national law of the Member State. The autonomous classification is, of course, not only relevant for the Parent-Subsidiary Directive but for any secondary EU law. It was subsequently also confirmed for the Merger Directive in the *Kofoed* case and the *A.T.* case and can therefore be considered settled case law of the ECJ.[490]

Interestingly, in his Opinion to the *Lankhorst-Hohorst* case, Advocate General Mischo concluded that the jurisprudence of the Court in the aforementioned *Athinaiki Zythopoiia* case could be transferred to the situation of a hidden distribution of profit. He outlined that "*(i)t seems to me that the considerations which led the Court of Justice, in the Athinaiki Zythopoiia case, (…) to classify the tax at issue in the main proceedings as a withholding tax are present in this case also.*"[491] It is important to note that the classification as a withholding tax under Article 5 (1) of the Parent-Subsidiary Directive and the identification of substitutes to such a tax on the level of the state of the subsidiary company are not the same as the classification of a profit distribution on the level of the state of the parent company. The Directive does not give any hint whether the provisions should also apply to deemed dividends. It seems to be quite logical, in my opinion, that hidden distributions of profit are covered by the Directive in the same way as any other regular (overt) dividend payment. One must be aware of the fact that a hidden distribution of profit typically requires some sort of (hidden) advantage for the shareholder or, at least, is somehow triggered by the shareholder relationship. That means it is either a direct reduction of the net asset value of the company or the company gives away the opportunity to increase the net asset value (e.g. by not charging services to the shareholder or related parties). The tax concept of a hidden distribution of profit focuses on the identification and the separation of profit and loss relevant transactions from mere profit distributions. It is therefore consistent, in my opinion, to treat the latter element in exactly the same manner as any regular distribution which is based on a formal decision of the shareholders. Pursuant to Scherer and Helminen, the Parent-Subsidiary Directive may be interpreted as also applying to such situations in which the domestic tax law of a Member State subjects a fictive distribution to taxation, as if an actual distribution had been made.[492] Schönfeld takes the same position, because this would otherwise allow the Member States to circumvent the Parent-Subsidiary Directive. According to

[488] Case C-294/99 (*Athinaiki Zythopoiia*).
[489] Case C-294/99 (*Athinaiki Zythopoiia*), paragraph 27; see in this respect also the cases C-197/94 and C-252/94 (*Bautiaa and Société francaise maritime*), paragraph 39.
[490] Case C-321/05 (*Hans Markus Kofoed v Skatteministeriet*), July 5, 2007; case C- 285/07 (*A.T. v. Finanzamt Stuttgart-Körperschaften*), December 11, 2008.
[491] Opinion of the Advocate General Mischo (case C-324/00 - *Lankhorst-Hohorst*), paragraph 110.
[492] Scherer, Doppelbesteuerung und Europäisches Gemeinschaftsrecht, 1995, page 226; Helminen, The Dividend Concept in International Taxation, 1999, page 209; Helminen, Dividend Equivalent Benefits and the Concept of Profit Distribution of the EC Parent-Subsidiary Directive, EC Tax Review 2000, page 161 et seq. (164). See in this respect also Breuninger, Zur Umsetzung der Mutter-Tochter Richtlinie nach dem Steueränderungsgesetz 1992, Europäisches Wirtschafts- und Steuerrecht 1992, page 88 and the criticism in Brokelind, Ten Years of Application of the Parent-Subsidiary Directive, EC Tax Review 2003, page 158 et seq. (159, 166). However, according to De Hosson the Directive should only be applicable to distributed profits (De Hosson, The Direct Investment Tax Initiatives of the European Community, 1990, page 427).

Schönfeld, the limitation to regular distributions would lead to the result that the avoidance of double taxation according to Article 4 (1) of the Parent-Subsidiary Directive would not be applicable to fictive distributions - with the effect of a possible over-taxation.[493] The Position Paper of the Fédération des Experts Comptables Européens (FEE) also comes to the conclusion that a deemed dividend falls within the scope of the Directive.[494] In any event, this question will be examined in more detail - with respect to income attributions under a CFC regime - in chapter 8. In this context, the amendment to the Directive regarding fiscally transparent entities will be considered as well.

4.3.2. Conclusions Regarding the Parent-Subsidiary Directive

The examination of the Parent-Subsidiary Directive and the case law of the ECJ shows that the classification of dividends - in the sense of the latter Directive - must be made according to objective characteristics and irrespective of the classification of dividends under the national legislation of the Member States. Further, it can be concluded that not only regular dividend distributions are within the scope of the Parent-Subsidiary Directive, but also hidden dividend distributions. The question arises whether other types of *deemed dividends* as well as current income attributions - which are not classified as dividends under national legislation - may fall within the scope of the Parent-Subsidiary Directive. The most important income attribution in the context of this study is, of course, the attribution based on CFC rules. However, this question will exclusively be examined in chapter 8 since it should not be part of the general verifications. In this respect, it is of great importance to take into account the amendment of the latter Directive regarding the treatment of fiscally transparent entities.

4.4. Conclusions

1.) The case law of the ECJ shows that the investment in another Member State may be protected, in principle, by the freedom of establishment, the freedom to provide services and the free movement of capital.

2.) The concept of establishment was described by the ECJ as the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period. The case law of the ECJ shows further that - in order to come within the scope of the freedom of establishment - the secondary establishment (e.g. in a legal entity) must confer definite influence over the company's decisions.

3.) It seems to be obvious that not each and every activity can be considered an economic activity. In order to come within the scope of the freedom of establishment, an economic output must exist which is created in the host Member State. The mere holding of assets or shares cannot be seen as the pursuing of an economic activity, but assets and shares can be seen as an "instrument" which may be utilised to carry out economic activities.

4.) The economic activity must be pursued through a fixed establishment. Based on the case law of the ECJ, such an establishment requires (i) the appearance of permanency, (ii) a management and (iii) has to be materially equipped for the

[493] Schönfeld, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht, 2005, page 407.
[494] FEE Position Paper, April 2002, page 15.

carrying out of the respective functions. Essentially, the establishment must be sufficiently equipped (premises, management, staff, equipment) in order to provide the respective services or any other functions on its own and without being a mere tool of execution of, for example, the parent company.

5.) In order to have a definite influence over the company's decisions and to determine its activities it is not necessarily required that a single shareholder has a majority interest in the company. In the *SGI* case a shareholding of 34 percent was sufficient to come within the scope of the freedom of establishment. The ECJ case law shows that even a combination of relatively low minority holdings of about 10 to 12.50 percent per shareholder, like in *Columbus Container*, can be sufficient if further elements are existent which show that a definite influence exists. This is the case, for example, if shareholders act together, e.g. by a common representative, and the (combined) shareholding confers such a definite influence. In general, no clear percentage of shareholding or voting rights can be derived from the case law. In my opinion, the national commercial and company law has to be referred to, but it seems to be apparent that a definite influence may also exist on a factual or contractual basis.

6.) The freedom to provide services requires the actual pursuit of an economic activity from either within the Member State of primary establishment towards the recipient in another Member State or with a temporary link to the Member State of the recipient of the services. Apparently, the freedom of establishment and the freedom to provide services both require the actual pursuit of an economic activity. Hence, there is a certain overlapping of the requirements to come within the scope of the latter two freedoms. Nonetheless, it is unlikely - at least for investments in the context of this study - that two activities will be covered simultaneously by the freedom of establishment and the freedom to provide services.

7.) The scope of the free movement of capital is much broader than the scope of the freedom of establishment (and basically also the freedom to provide services) and also encompasses any type of portfolio investments. A significant difference to the freedom of establishment is therefore the fact that - in order to come within the scope of Article 63 of the TFEU - the investment in a company in another Member State neither requires a definite influence over the company's decisions nor the actual pursuit of an economic activity. Moreover, it is important to note that the scope of the free movement of capital is not limited to investments in other Member States but Article 63 of the TFEU is equally relevant for investments in non-member states.

8.) The scope of the above basic freedoms is one thing, but the "ranking" of these freedoms among each other is another. In other words, the decisive question in a situation in which the basic freedoms are theoretically affected simultaneously is whether there is a certain form of order among these freedoms and whether there is a prevailing freedom which takes preference over another freedom (or other freedoms). The outcome of the examinations of the TFEU and the case law of the ECJ can be summarised as follows:

- *The freedom of establishment vs. the free movement of capital:* the more recent case law of the ECJ provides a better understanding of the relationship between these two freedoms. Based on this case law, the purpose of the national legislation must be considered for the decision which of the basic freedoms is affected. If the purpose of the legislation is the application to investments which confer a definite influence over a company's decisions, it is the freedom of establishment which is to be exclusively examined. The purpose of the legislation can be identified not only by quantitative elements (e.g. percentage of participation), but also by qualitative elements (e.g. collaboration of shareholders to achieve a definite influence). If the purpose of the legislation is the general application to all types of portfolio and entrepreneurial investments, the freedom of establishment and the free movement of capital can, in principle, both be affected. However, if the actual investment confers definite influence over a company's decisions and the purpose of the legislation is linked to the objective of exercising the freedom of establishment, the ECJ - in its examination - gives preference to the freedom of establishment. In contrast thereto, if the link does not exist and the '*free movement of capital aspect'* prevails, the ECJ gives preference to the free movement of capital. If the examination results in the conclusion that a restriction on one of the freedoms exists which cannot be justified, the ECJ refrains from additionally examining whether the TFEU provisions on the other freedom also preclude the respective legislation.

- *The freedom of establishment vs. the freedom to provide services*: the case law of the ECJ made it clear that the freedom of establishment does not necessarily prevail over the freedom to provide services. In *Fidium Finanz* the ECJ held that Article 57 (1) of the TFEU relates to the definition of the notion of 'services' and does not establish any order of priority between the two basic freedoms. In the *Cadbury Schweppes* case, the ECJ concluded that - with respect to the UK CFC legislation - the restrictive effects on the freedom to provide services are an unavoidable consequence of any restriction on the freedom of establishment.

- *The freedom to provide services vs. the free movement of capital*: In the relationship between Article 56 of the TFEU and Article 63 of the TFEU it is - again - the more recent case law of the ECJ which provides a clearer picture. Based on this case law, it seems that the purpose of the national legislation is decisive. If the national legislation clearly focuses on services, e.g. the supervision of services, there is apparently no room for any (additional) examination of the free movement of capital. On the other hand, one should also conclude from this jurisprudence that national legislation which is foremost directed towards the investment (as such) - and not the services provided by the investment (e.g. the respective legal entity) - the prevailing freedom should be the free movement of capital and not the freedom to provide services.

9.) It is obvious that the fact that one basic freedom may prevail over another basic freedom can have important consequences. The most important consequence is, in my opinion and in the context of this study, related to the free movement of capital: the latter freedom is the only basic freedom which can also be invoked in case of investments in non-member states. Thus, if another freedom prevails over the free movement of capital - with the effect that Article 63 of the TFEU cannot be invoked anymore - the door for a protection of the investment in a non-member state (based on the TFEU) is closed. However, what is clear from the more recent case law is the fact that the purpose of the national legislation remains the decisive element for the decision whether the freedom of establishment or the free movement of capital will be examined. Consequently, if the national legislation is not linked to the objective of exercising the freedom of establishment and the '*free movement of capital aspect'* prevails, there will be an exclusive examination of the free movement of capital.

10.) Given the importance of the basic freedoms for individuals and entities, it is obvious that situations exist in which the basic freedoms are abusively invoked just for the purpose of taking advantage of these freedoms without being entitled to do so. It is equally obvious that Member States apply rules in order to prevent such situations. However, the case law of the ECJ shows that the abuse of the basic freedoms must be determined case-by-case and cannot be generalised. In my opinion, the case law with respect to VAT does not lead to another outcome.

11.) The question whether the application of national measures leads to a restriction on the exercising of the freedom of establishment, the freedom to provide services and / or the free movement of capital shall be examined in the context of the concrete legislation. This question will therefore be examined exclusively in chapter 8.

12.) There are a number of justifications for a restriction on the exercising of the freedom of establishment, the freedom to provide services and the free movement of capital. The justifications are either included in the TFEU itself or can be derived from the case law of the ECJ. The latter justifications are recognised under the rule of reason as overriding reasons of public interest and are of great importance, especially in cases dealing with direct taxation. The examination was mainly concentrated on justifications based on the rule of reason which have already come up in previous decisions and which might somehow be relevant in the context of this study. Thus, the examination of the justifications should provide a general basis for the more specific verifications in chapter 8.

13.) The examination shows that there are limited possibilities for the Member States to justify restrictions on the aforementioned basic freedoms. Some justifications have never been accepted, especially those which were merely based on budgetary or economic reasons, including justifications based on the erosion of the tax base and the loss of tax revenue, as well as the general compensation for advantages. Administrative inconvenience was rejected by the ECJ in earlier cases, but from the more recent case law one might have the impression that the ECJ is more open now for arguments which are linked to administrative inconvenience. A justification based on a different taxation in another Member State must be seen in the context of the respective national legislation. If it comes close (or is even identical) to the argument based on the erosion of the tax base, the loss of tax revenue or the general compensation for advantages, it cannot be accepted as a valid justification. The principle of territoriality and the protection of a balanced allocation of power to impose taxes between Member States were both accepted by the ECJ and might play a role in future decisions as well. Other justifications, like the cohesion of the tax system, the effectiveness of fiscal supervision or the aim of preventing tax avoidance, can be acceptable under certain - very limited - circumstances. The reason is that restrictive measures applied by the Member States have to be appropriate for the protection of the recognised public interest and proportionate to the aim pursued. They cannot go beyond what is necessary to achieve the aim of the provision. Thus, Member States are required to apply those measures which are the less restrictive to achieve the aim pursued.

14.) With regard to the justifications, it is clear from the case law of the ECJ that it can be necessary to make a differentiation between an investment in a Member State and an investment in a non-member state. In other words, it may be the case that a restriction on the free movement of capital to or from third countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States. The movement of capital to or from third countries takes place in a different legal context from that which occurs within the EU, e.g. with respect to the application of the Council Directive 77/799/EEC. Nevertheless, a Member State may have concluded double tax conventions and / or other agreements with third countries which may result in legal obligations which are comparable to those which are existent in the EU. In this case, it may be difficult for a Member State to demonstrate that a justification is to be “weighted” differently. Therefore, the differentiation is not limited to the question whether the country of investment is a Member State or non-member state, but also requires a differentiation among the non-member states. However, it is clear that the national measure must still be proportionate in relation to the aim pursued, no matter whether it is related to Member States or non-member states.

15.) From the perspective of secondary EU law it is the Parent-Subsidiary Directive which might be of general importance. In my opinion, the examination of the Parent-Subsidiary Directive and the jurisprudence of the ECJ in this respect shows that the classification of dividends - in the sense of the latter Directive - must be made according to objective characteristics and irrespective of the classification of dividends under the national legislation of the Member States. In principle, this covers regular and hidden dividend distributions. The question whether other types of income attributions are covered by the Parent-Subsidiary Directive, namely those which are based on the application of CFC rules, will be examined in chapter 8. The amendment to the Parent-Subsidiary Directive will be taken into account in this context as well.

Part III - CFC and FIF Legislation in the European Union and the Alternative CSC Concept

5. General Aspects of CFC and FIF Legislation

5.1. Introduction

The controlled foreign company rules (CFC rules)[1] are an important part of the domestic legislation in nearly half of the EU Member States[2] and it is - in my opinion - likely that the number of countries which enact a CFC regime will increase in the future.[3] The reasons are, *inter alia*, the immense differences in corporate income tax rates - on a global scale - and the increased possibility to shift capital from one country to another and therefore to earn income even in the remotest parts of the world.[4]

In addition, some of the Member States enacted so-called foreign investment fund rules (FIF rules). However, the latter rules are not as widespread as the CFC rules and can, in general, be seen as a part of the domestic CFC legislation.[5] Thus, in the following, the term "CFC" will cover both, the CFC and FIF rules, unless a differentiation is required or more appropriate. The main differences between CFC and FIF rules will be outlined below.

A significant number of the Member States which have not enacted CFC rules apply tax rules which can have a similar economic effect, even though they cannot be considered CFC rules in a narrower sense.[6] The various types and the specific elements of European CFC rules will be verified in detail in the subsequent chapter. In the following, the general aspects of CFC taxation will be outlined: the current taxation of income, the basic requirements which exist in almost all of the countries which apply such rules, the main differences between CFC and FIF rules, and the

---

[1] Sometimes also called controlled foreign corporation rules.

[2] In the year 2005, 12 of the 25 Member States (48 percent) have enacted CFC rules (Denmark, Estonia, Finland, France, Germany, Hungary, Italy, Lithuania, Portugal, Spain, Sweden, the United Kingdom). See in this respect also Fédération des Experts Comptables Européens (FEE), FEE Position Paper on Controlled Foreign Company Legislations in the EU, April 2002, and the earlier overview of Kaufmann, Controlled Foreign Companies (CFC)-Gesetzgebung - Übersicht über die Rechtslage in den EU-Mitgliedstaaten, Steuer und Wirtschaft International 2001, page 16 et seq.; national reports are included in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004; International Fiscal Association (IFA), Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, 2001 San Francisco Congress; Sandler, Tax Treaties and Controlled Foreign Company Legislation - Pushing the Boundaries, The Chartered Institute of Taxation, 1998 (overview in the appendix). See also the earlier overview in: OECD - Studies in Taxation of Foreign Source Income, Controlled Foreign Company Legislation, 1996.

[3] See also Lang, CFC-Gesetzgebung und Gemeinschaftsrecht, Internationales Steuerrecht 2002, page 217 (the English version of the article "CFC Legislation and Community Law" was published in European Taxation 2002, page 374 et seq.; see also the OECD recommendations included in the OECD Report on Harmful Tax Competition (see in more detail below). The Austrian Ministry of Finance has presented a draft of an Austrian Foreign Tax Act (CFC legislation), included as an annex to Gassner / Lang / Lechner, Der Entwurf eines österreichischen Außensteuergesetzes - Grenzen der Gestaltung (2001).

[4] This is not only true for the „normal" passive activities but also for business activities which have come up in the course of the last few years, e.g. electronic commerce (see with respect to e-commerce and CFC taxation: Doernberg / Hinnekens / Hellerstein / Li, Electronic Commerce and Multijurisdictional Taxation - Applying Current Multijurisdictional Income Tax Rules to Electronic Commerce, 2001, pages 320 - 337).

[5] For example in Germany.

[6] For example, Austria, Belgium, Luxembourg, and the Netherlands (see in this respect also FEE Position Paper, page 5).

policy rationale for those regimes. I will go into detail of the concept of deferral, the alleged alternative measures, and the ability-to-pay principle in the context of CFC taxation. Moreover, the legislation will be compared to the taxation of permanent establishments and partnerships. Last of all, the OECD and EU efforts against harmful tax competition will be outlined.

5.2. The Current Taxation of CFC Income

What makes the CFC taxation somehow “unique” is the fact that income derived by a foreign legal entity is subject to current taxation in the hands of the resident shareholder. That means, despite the fact that the foreign legal entity is considered to be non-transparent for tax purposes,[7] the income is directly allocable to the resident taxpayer - even though an actual profit distribution does not take place. This has the significant consequence - for tax purposes - that the income derived by the foreign legal entity cannot be sheltered through the corporate veil. The current allocation of income according to the CFC rules takes away any flexibility with respect to the question if and when the income of the foreign legal entity becomes subject to domestic taxation through an actual profit distribution. Moreover, and even more important, it can lead to the taxation of foreign source income on a domestic corporate level which would otherwise be outside of the scope of domestic taxation.[8]

5.3. The Basic Requirements for the Application of CFC Rules

There are three basic requirements for the application of CFC rules which exist in almost all of the EU Member States which have enacted a CFC regime. The basic requirements are:

> a.) The foreign entity must derive certain passive income (tainted income)
>
> With very few exceptions, the CFC rules of the EU Member States only apply to certain passive income[9] and to income which is derived by entities with mainly passive activities.[10] Active income is typically outside of the scope of CFC regimes: Either through a direct active-passive separation (transactional approach) or through the provision of exemptions for active businesses (entity approach).[11] Thus, there is - in general - no unlimited allocation of income based on the CFC regimes.
>
> b.) The ownership in the foreign entity
>
> All of the countries which apply a CFC and FIF taxation require a shareholding in the foreign entity.[12] In most cases, a minimum threshold is necessary for the application of the CFC and FIF taxation. The percentage of shareholding, however, can deviate considerably.

---

[7] From the perspective of the state of residence of the shareholder.
[8] In case the exemption method is applied to the profit distributions.
[9] The so-called transactional approach.
[10] The so-called entity approach.
[11] In case of an entity approach: If the foreign company carries on mainly active businesses.
[12] Leaving aside the constructive ownership rules. The constructive ownership rules will be discussed in more detail below.

c.) The income must be low-taxed

The requirement of low-taxation is of importance in all of the countries which apply CFC regimes. The current taxation of income only takes place if the effective tax rate in the foreign country deviates to a certain predetermined extent from the tax rate theoretically applicable on the respective income in the residence country of the shareholder.[13]

The basic requirements will be outlined in more detail below. However, they can give a first impression on the concept and therefore "the face" of CFC regimes. It is not only the effect which is similar in the countries which apply such legislation but also the basic requirements for the application of the CFC taxation.

5.4. The Main Differences between CFC and FIF Rules

Very generally, the main differences between CFC and FIF rules can be described as follows: (i) FIF rules already apply to very small and insignificant shareholdings, whereas CFC rules require in most cases a participation of at least 10 percent or more, and (ii) FIF rules are often only applicable to certain types of passive investment income but not generally to the wide range of passive income which is in the scope of CFC taxation. The reason for the low participation threshold and the concentration on passive investment income is mostly due to the fear of an increased risk of national tax base erosion. Residents may defer domestic taxation by acquiring shares in - for example - mutual funds. If such funds are widely owned, they will not be controlled by a small group of resident shareholders; nor will any one resident shareholder own a significant interest in the fund.[14] Thus, such investors will not be subject to CFC taxation since they do not reach the required participation threshold. The FIF provisions can basically be seen as a part of (or a supplement to) the CFC rules which are often embedded in the respective CFC legislation. In some cases, I would even consider the CFC legislation to be a "mixture" of CFC and FIF rules. For example, the German Foreign Tax Act[15] requires, in general, that German investors own, directly or indirectly, at least 50 percent of the shares, the voting rights, or dividend rights at the end of the financial year. If the threshold of 50 percent is reached, the tainted income will be allocated to all resident shareholders regardless of the size of their shareholding in the foreign entity.[16] Thus, the small investment in a mutual fund - to a large extent owned by German investors - will already be covered by the CFC regime.[17] In addition, a separate threshold exists for passive income of a capital investment kind: if the income of the foreign entity includes passive income of a capital investment kind and the shareholding in the foreign entity is at least one percent, the income will be allocated to the resident shareholder unless the income of a capital investment kind comprises only a minor part of the whole income.[18] If the foreign entity exclusively or almost exclusively derives gross revenues of a capital

[13] Typically stipulated as a fraction or a percentage of the domestic tax rate.
[14] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 101.
[15] The German CFC legislation is embedded in the German Foreign Tax Act (*Außensteuergesetz*).
[16] Section 7 (1), (2) of the German Foreign Tax Act.
[17] Similar provisions exist in other EU countries, even though a threshold often remains, e.g. in Portugal (reduction to 10 percent) and France (reduction to 5 percent). See in more detail below.
[18] Thus, the rules apply even though German shareholders own – in total – less than 50 percent in the CFC.

investment kind, the income will be attributed to the resident shareholder - irrespective of the percentage of shareholding.[19]

In most cases, the conclusions which will be drawn below with respect to the CFC rules are equally relevant for the FIF rules. As already outlined above, I will only mention the FIF rules separately where it is required in the respective context or where it is more appropriate. Otherwise, the term “CFC” will cover both, the FIF and CFC rules.

5.5. The Policy Rationale for CFC Rules

In theory, there can be several reasons why a country introduces a CFC regime and taxes certain types of income on a current basis which would otherwise be sheltered from domestic taxation based on the principle that a foreign legal entity is to be considered a separate taxpayer. Taking into account the aforementioned basic requirements, especially the fact that CFC taxation is only applied to certain low-taxed passive income, the *anti-avoidance approach* becomes obvious. The CFC rules can fulfil the following requirements:[20]

a.) As a general “anti-deferral” measure: the CFC regimes are directed to counteract techniques used by taxpayers to obtain tax deferrals by simply interposing a foreign corporate structure between themselves and the source of income. It can be seen as a broad anti-deferral regime which applies to certain low-taxed passive income - irrespective of the source of income.

b.) As a defensive measure against the investment in tax havens and in jurisdictions with a preferential tax regime.

c.) As a tax policy measure against the erosion of the domestic tax base and to reduce the outflow of capital towards low-tax countries.

d.) As a supplementary legislation to transfer pricing rules: the shifting of profits from high-tax countries to low-tax countries is less attractive in case of CFC taxation, and the transfer pricing issues are of less importance for the tax authorities.[21] However, since CFC rules are limited to certain passive income and base company income, the effect will be rather limited. The difficulties typically arise in case of active businesses (supply of goods and services) and not to a comparable extent for passive activities. In my opinion, the fact that transfer pricing adjustments become less important if CFC rules apply simultaneously can be seen as a positive “side effect.”

e.) As a supplementary legislation to the residence test: especially in case of passive investments, the determination of fiscal residence (or the place of effective management) can be difficult. Also in this situation, the assessment in case of passive activities becomes less important if the income is taxed according to the CFC rules anyway.

[19] Section 7 (6), (6 a) of the German Foreign Tax Act; see in more detail Portner, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International, September 30, 2002, page 1679 et seq.
[20] See the FEE Position Paper, pages 4 and 5.
[21] Since it will be subject to domestic taxation in the country of the shareholder anyway.

The structure of the CFC regimes emphasises the general anti-deferral approach which - of course - not only prevents the sheltering of income derived in tax havens and jurisdictions with a preferential tax regime, but also prevents the deferral of domestic taxation on passive income derived in low-tax countries with a non-preferential tax regime. It is therefore also important to have a closer look at the concept of deferral. In fact, CFC taxation can make foreign passive investments unattractive - especially in those cases where taxation is one of the main factors for the investment decision.

The current attribution of low-taxed passive income ensures - from the perspective of the state of residence of the shareholder - the limited application of the principle of capital export neutrality. I will go into more detail of that aspect later on.

5.6. The Concept of Deferral

5.6.1. General Aspects

CFC legislation can be seen as an anti-deferral regime which is directed to stop deferral of domestic taxation on foreign source income in certain situations and under certain conditions.[22] It is therefore important to know what the "deferral privilege" actually means.[23] In general, deferral can be seen as any situation in which a country taxes foreign source income earned by resident individuals or corporations directly or indirectly through a foreign corporation, trust, or other entity, not as such income is earned, but only when the income is actually received by the resident taxpayers.[24] As already described earlier, deferral of the domestic taxation on foreign source income is in line with the economic principle of capital import neutrality. However, even those countries which generally follow the economic principle of capital export neutrality typically recognise foreign corporations as separate taxable entities, with the effect that the income derived by the foreign corporations is not currently taxed in the residence state of the shareholder. *Arnold* characterises the deferral of domestic tax on the foreign source income as an "unintentional by-product of the fundamental tax principles that a foreign corporation is a separate taxable entity and is usually considered to be non-resident for tax purposes."[25]

However, the effect of deferral can be illustrated best by using examples. Supposing a holding company situated in country A (company A) holds all of the shares in a subsidiary company in country B (company B). The income generated in country B is taxed with a rate of 10 percent whereas the income in country A is subject to an income tax of 30 percent. The latter country applies a credit system to avoid double taxation caused by a dividend distribution of the subsidiary company B to the holding company A. Assuming that company B derives a taxable income of 100 Euro at the end of the year 01, the income tax in country B would be 10 Euro[26] and the remaining

[22] See for example Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 39.
[23] See with respect to the "deferral privilege" Robert J. Peroni, J. Clifton Fleming Jr., Stephen E. Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 S.M.U. Law Rev. 455 (1999), page 457.
[24] Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation (1986), page 83.
[25] Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation (1986), page 85.
[26] 10 percent tax rate in country B applied to a taxable income of 100 Euro.

amount for reinvestment or distribution would be 90 Euro. If it is further assumed that the amount of 90 Euro is reinvested in year 02 and the return on investment is 10 percent, the taxable result in country B – only related to the reinvested amount of 90 Euro – would be 9 Euro.[27] This, in turn, would lead to an after tax result of 8,10 Euro in year 02.[28] At the beginning of year 03, and after the deduction of the income tax in country B, the total amount which can be subject to profit distribution or further reinvestment is 98,10 Euro.[29]

In contrast, if the assumed income of 100 Euro derived in country B is subject to current taxation in country A, the result will be different. Assuming that country A taxes the 100 Euro immediately after the end of the year 01 with the domestic tax rate of 30 percent and allows a full tax credit for the foreign income tax applied in country B with 10 percent, an additional 20 Euro would have to be paid in country A which cannot be subject to any further reinvestment. In this example, it is assumed that company B has to transfer the amount of 20 Euro to company A in the form of a profit distribution in order to enable company A to pay the additional domestic income tax on the 100 Euro attributed income. Therefore, company B has - at the beginning of year 02 - only the possibility to reinvest the net amount of 70 Euro. A return on investment of 10 percent would lead to a pre-tax profit on the reinvested amount of 7 Euro and an after-tax profit (in country B) of 6,30 Euro at the end of year 02.[30] However, if the profit related to the reinvested financial means is again subject to current taxation in country A, the additional tax burden right at the end of year 02 will amount to 1,40 Euro.[31] Following the same pattern as described above, the additional tax burden of 1,40 Euro has to be covered by a distribution of company B to company A. At the beginning of year 03, and after the deduction of all income taxes, the total amount which can be subject to profit distribution or further reinvestment is 74,90 Euro.[32]

Coming back to the first scenario, it is assumed that the total amount of 98,10 Euro is distributed immediately after the end of the year 02. This would lead to an additional taxation in country A of 21,80 Euro.[33] Thus, the net amount after tax which would be available for company A at the beginning of year 03 is 76,30 Euro.[34] That means, if the scenario of a one-year deferral followed by a profit distribution is compared to the scenario of a current taxation of income, a difference of 1,40 Euro can be identified.[35] This is exactly the amount of after-tax income which is related to the difference between 90 Euro reinvestment and 70 Euro reinvestment.[36] That means the difference of 20 Euro remains available for reinvestment until the “principal amount of income” of 100 Euro is subject to tax in country A. This will then have the effect that

---

[27] Under the assumption that the income tax of 10 Euro is immediately transferred to the tax authorities at the beginning of year 02 or is at least not available in year 02 for any partial reinvestment.

[28] 9 Euro minus income tax of 0,90 Euro (10 percent).

[29] 90 Euro plus 8,10 Euro. Again, under the assumption that the income tax is levied at the end of the year 02 (or immediately after the end of the year 02).

[30] 7 Euro minus income tax of 0,70 Euro.

[31] Income tax of 2,10 Euro (7 Euro x 30 percent) minus tax credit of 0,70 Euro.

[32] 70 Euro plus the net amount of 4,90 Euro.

[33] The gross amount of 109 Euro (100 Euro plus 9 Euro) would be taxed with 30 percent. The income tax in country A would be 32,70 Euro and a foreign income tax of 10,90 Euro (10 Euro plus 0,90 Euro) would be credited. The remaining tax burden would be 21,80 Euro (32,70 Euro minus 10,90 Euro).

[34] 98,10 Euro minus 21,80 Euro. Under the assumption that the additional tax burden in country A is immediately payable or is, at least, not available for further investments in year 03.

[35] 76,30 Euro minus 74,90 Euro.

[36] 2 Euro (20 Euro x 10 percent yield for one year) minus 0,60 Euro (30 percent income tax).

the 20 Euro investment is transferred into 20 Euro tax. However, in the meantime the deferred tax can be used to produce additional income in country B. Even though the additional income will also be subject to the increased domestic tax in country A, the (after-tax) benefit of 1,40 Euro remains existent even when a complete taxation of the foreign income in country A takes place.

Supposing the amount of 98,10 Euro is not distributed immediately after the end of year 02 and the companies A and B are of the opinion that it makes more sense to accumulate the profits within company B, the effect of deferral becomes much more obvious. The amount of 98,10 Euro produces additional after-tax income of 8,83 Euro (year 03), 9,62 Euro (year 04), and 10,49 Euro (year 05).[37] The original after-tax income of 90 Euro will be increased to a total amount of 213,06 Euro after a reinvestment period of ten years.[38] This can now be compared to the situation where the income derived by company B is subject to current taxation in country A. The after-tax return will only amount to 5,24 Euro (year 03), 5,61 Euro (year 04), and 6,00 Euro (year 05). The original after-tax income of 70 Euro will be increased to a total amount of 137,70 Euro after a reinvestment period of ten years. In effect, the original difference of 20 Euro will grow to a total difference of 75,36 Euro.[39] The reason for this difference is obvious and can be separated into the following parts:

a.) The original difference of 20 Euro produces additional income with an after-tax rate of 9 percent. This results in a total amount of 47,35 Euro after ten years of reinvestment. It is the complete return of 9 percent which is “new” and which can only be derived because of the non-existence of a current taxation in country A. In effect, it is the prospective income tax of country A which can be invested – fully and to an unlimited extent – for the production of new income.[40]

b.) The “basic amount”[41] of 70 Euro produces after-tax income with a rate of return of 9 percent in the absence of a current taxation in country A, and 7 percent where a current taxation takes place in country A. The accumulated difference amounts to 28,01 Euro over a period of ten years.[42] It is therefore a difference of 2 percent, applied on the basic amount, which has an additional positive effect on the future earnings.

Very generally, the progressive increase of the income difference is due to (i) the possibility of an investment (and further reinvestment) of the prospective income tax of country A and (ii) the higher effective return on investment of the basic amount (followed by further reinvestment of the proceeds). However, it should be clear that the impact on the business activities of company B is not necessarily limited to the respective difference. For example, the accumulated positive income difference increases the equity of company B. This can have a positive impact on the rating of

[37] Always under the assumption of a return on investment of 10 percent (before tax) and an income tax of 10 percent, i.e. an after tax return on investment of 9 percent per year.
[38] Which is the period from the beginning of the year 02 until the end of year 11.
[39] 213,06 Euro minus 137,70 Euro.
[40] It is the “prospective income tax” which can be invested since it is unclear whether the income tax actually has to be paid. For example, if the company suffers massive losses in following years which have to be offset against the retained earnings, there will be no future profit distribution and therefore no additional income tax in country A.
[41] I call it basic amount since it is available in both scenarios, i.e. with and without current taxation.
[42] 165,71 Euro (70 Euro / 9 percent over ten years) minus 137,70 Euro (70 Euro / 7 percent over ten years).

the company and its debts. Any improvement of the rating can have the consequence of a lower interest rate on the outstanding debts in general. Thus, the effect can go far beyond the pure mathematical difference which is calculated above.

The differences caused by the deferral of domestic taxation on foreign source income depend on two main factors: the period of deferral and the rate of return. The longer the period of deferral and the higher the rate of return, the higher the difference caused by the deferral of income. Or from another perspective: an extremely long period of deferral – combined with a high interest rate – can have the theoretical effect of income exemption.[43] For this reason, deferral is often considered to be a reduction of the effective tax rate in the country of the parent company or an "interest free loan" granted to the domestic parent company from the jurisdiction which allows the deferral.[44] The benefits are therefore commonly illustrated in the form of a discounted future tax burden or in the form of accumulated and avoided future (after-tax) interest expenses.[45] However, it is more convincing to describe deferral as a kind of "forced equity investment" of the domestic government into the foreign company.[46] The reason is very simple: if the profit of company B in year 01 is completely offset by a corresponding loss in year 02, there will be no possibility for a profit distribution. Country A would therefore not be in a position to claim the potential taxes related to year 01 in the future. In case of an interest free loan this should be different since the "principal amount" (tax) would theoretically still be subject to repayment. Tax deferral has therefore rather features of an equity investment than of a debt investment. The total amount of tax in the country of the parent company fully depends upon the success of the foreign investment. And even though the total amount of aggregated income is taxable as soon as the retained profit is distributed to the parent company, or after liquidation of the foreign investment, it must be recognised that during that period the foreign company is in a position to create additional values which is only possible because of the tax deferral. Even though the effect of deferral can be calculated and determined if the rate of return and the total period of deferral is given, the question remains to what extent the benefit of deferral can be seen as a "privilege" and to what extent is has to be recognised as a necessity which is caused by economic and other aspects. If one follows the argumentation that the income derived by the foreign entity - and which is above the risk-free interest component of capital - is necessary to cover the risks related to the passive activities, deferral cannot be seen as a privilege. The foreign entity should have the possibility to use the amount of income which is above the risk-free interest component of capital in order to cover those risks. However, if the risk-free interest component is a theoretically separable part of the foreign passive activities, there is no necessity for a tax deferral related to this component. Thus, the deferral of domestic taxation which

[43] The present value of an amount of 1 Euro discounted with an interest rate of 25 percent over a period of 20 years is approximately 0,012 Euro.
[44] See for example Gustafson / Peroni / Pugh, Taxation of International Transactions (1997), page 337; Isenbergh, International Taxation (1999), 1.22; Green, The Future of Source-Based Taxation of the Income of Multinational Enterprises, 79 Cornell Law Rev. 18 (1993), page 34; Peroni / Fleming Jr. / Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 S.M.U. Law Rev. 455 (1999), page 465; Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation (1986), page 88.
[45] See for example the tables in Peroni / Fleming Jr. / Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 S.M.U. Law Rev. 455 (1999), page 465 and Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation (1986), page 89.
[46] See in this respect Peroni / Fleming Jr. / Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 S.M.U. Law Rev. 455 (1999), page 465

is related to the (theoretically separable) risk-free interest component of capital can be seen, in my opinion, as a privilege and not as a necessity.

5.6.2. Deferral and the OECD Methods of Avoiding Double Taxation

In general, and as already described above, deferral is of particular importance in cases where (i) the credit method is applied for the avoidance of double taxation in the country of the parent company and (ii) where the income tax applied to the distributed income in the country of the parent company is higher than the foreign income tax which is credited against the domestic income tax. If the income tax in the country of the parent company is *lower* than the foreign income tax, deferral will not be an issue. The opposite would be the case: financial means which are not necessarily required in the high-tax country of the subsidiary would flow to the low-tax country of the parent company, i.e. typically also by way of profit distribution.

It can be argued that deferral does not play any role if the country of the parent company applies the exemption method instead of the credit method for the avoidance of double taxation.[47] Surely, a profit distribution does not lead to an additional taxation if the distribution is exempt from domestic taxation.[48] However, it should be clear that in a situation of a major difference in income tax rates between the parent company (high-tax country) and the subsidiary company (low-tax country) there is still an incentive to keep the income in the low-tax country. In my opinion, there is an increased likelihood that financial means – even though not necessarily required for the core business activities of the subsidiary company – will not be distributed to the parent company but instead used for other non-core business activities, e.g. the financing of other group companies and portfolio investments. This is not a deferral of domestic taxation of foreign source income in the aforementioned sense – because it would not be taxed in case of a distribution – but it may keep financial means, and therefore the basis for the production of new income, away from the country of the parent company. Or from another perspective: the non-distribution of foreign source income reduces the possibility of the parent company to create and increase taxable domestic income.

5.7. Alleged Alternative Measures for CFC Rules

In the following, I will briefly describe other anti-avoidance measures and clarify whether those measures can have an effect which is similar to CFC taxation. Some of the countries which do not have a CFC legislation apply one or more of the following measures and it should therefore be verified whether those measures can be a substitute for CFC taxation. However, in order to avoid the overlapping with other chapters, especially the part of the study which deals with the development of an alternative for CFC taxation, I will not go into too much detail.

[47] See in this respect Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation (1986), pages 83 and 84.

[48] Some states calculate an amount of 5 percent of the exempt profit distribution which has to be added-back to the income of the parent company. The measure is directed at eliminating the expenses which are related to the exempt distribution. However, this shall be of no relevance in this context.

5.7.1. Thin-Capitalisation Rules

Thin-capitalisation rules are widespread measures against the under-capitalisation of entities and therefore the increased deduction of interest expenses.[49] The thin-capitalisation rules are measures against the erosion of the domestic tax base but cannot be considered anti-deferral regimes. In contrast to CFC taxation, it is the tax base of the domestic entity which is "protected" from "excessive" deductions of interest payments. These provisions typically stipulate a certain debt-equity ratio according to which interest expenses are deductible. Excessive interest payments are qualified as profit distributions or non-deductible expenses. In general, the risk of excessive interest expenses exists in situations where the tax rate in the country of the debtor is higher than the tax rate in the country of the creditor - and typically not vice versa.[50] Thus, the thin-capitalisation rules are in theory capable of saving the domestic tax base up to a certain degree, but have a totally different target compared to anti-deferral regimes like the CFC rules. The existing thin-capitalisation rules can therefore not be used as a substitute for CFC taxation.[51]

5.7.2. Transfer Pricing Rules

Transfer pricing rules are of great importance in international taxation for the determination and the allocation of income between related parties. The centre of international transfer pricing practice is the "arm's length principle," which is typically the basis for the determination of considerations for sales and services, and profit shares among related parties for tax purposes.[52] It is of utmost importance that each corporation, partnership or permanent establishment receives the amount of taxable income which is – from a third party perspective – equal to the functions exercised and risks taken. Without such transfer pricing rules there would be an increased risk of profit allocations in favour of low-tax countries and to the detriment of high-tax countries. However, it must be very clear that even though transfer pricing rules are required for the determination of income of a CFC, they cannot fulfil the purpose of CFC taxation and can by no means be a substitute for CFC rules. For example, if a financing function is exercised by a CFC, the arm's length consideration will typically be derived from a comparable interest rate in an uncontrolled transaction. Transfer pricing rules fully accept the deferral and accumulation of arm's length interest income. CFC legislation equally accepts the arm's length interest income as such but "attacks" the deferral of income, which is not – and cannot be – in the scope of transfer pricing regulations. To be precise, I think that transfer pricing regulations can play an important role in stipulating the "correct" income on a transactional basis, e.g. in case of sales, financing, leasing, and other services, but cannot be used as an effective tool to target the accumulation of foreign source income.

---

[49] In the past, it was typically the relation of a domestic subsidiary towards a foreign parent company (or another foreign group company) which was in the focus of the thin-capitalisation rules. However, after the *Lankhorst-Hohorst* decision of the European Court of Justice the situation within the European Union is different: Some Member States do not apply those provisions to other Member States anymore (e.g. Spain), other Member States decided to expand the provision to domestic parent-subsidiary situations (e.g. Germany).

[50] Of course, situations exist where excessive interest expenses can make sense even if the tax rate in the country of the creditor is higher, e.g. in case of an existing tax loss carry forward in the country of the creditor.

[51] The OECD Report on Harmful Tax Competition outlines that *"(...) some domestic rules, such as the setting of safe harbour debt/equity ratios, may be misused and thereby facilitate harmful tax competition*" (see Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 168).

[52] See with respect to the arm's length principle: OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995), chapter 1.

5.7.3. Residence Test

A residence test is typically focused on the place of effective management of the foreign company.[53] Pursuant to those rules, the foreign company may be considered to be resident where its controlling shareholders are resident.[54] The latter, however, should only be true if the controlling shareholders are actively involved in the management of the company from within their state of residence. The mere fact that the shareholders control the company through their percentage of shareholding or voting rights is, in my opinion, by no means sufficient. Consequently, deferral does not play a role anymore since the foreign company with the place of effective management in the country of the shareholder would be taxed according to the domestic tax rules, and the domestic income tax rate would be imposed on the respective income.[55] In a very broad sense it can be considered an anti-deferral regime. It is interesting to see that the residence test is of particular relevance in countries without CFC legislation and in countries where the CFC legislation is limited to very specific activities.[56]

However, it has to be kept in mind that a residence test may be successful in case of letter box companies or tax haven structures where it is sufficiently clear that the foreign company is effectively managed from within the country of the shareholder. In the important case of a foreign subsidiary which carries out certain business functions, e.g. leasing, financing and other services, and where the management is effectively exercised from within the foreign (low-tax) country, the residence test cannot be successful. This is even true where the foreign company is fully dependent upon the domestic shareholder.[57] Furthermore, it is unlikely that the other contracting state would follow the domestic approach in situations where it is not sufficiently clear and obvious. It is therefore a provision which can lead to permanent conflicts if it is not restricted to letter box companies and tax haven structures.[58] These are arguments against a broader definition of residence, e.g. in a way that all foreign corporations which are incorporated abroad but controlled by residents could be treated as resident for domestic purposes. Such legislation would theoretically encompass all foreign activities, irrespective of their nature.[59] Moreover, it would

---

[53] The place of effective management is also the relevant criterion in the OECD-MTC. Article 4 (3) of the OECD-MTC states that if *"(...) a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated."*

[54] See in this respect also Arnold, The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation (1986), page 107.

[55] Another approach is the creation of a permanent establishment in the country of the shareholders instead of considering the foreign company to be a resident company. Such an approach was followed by the Dutch Supreme Court, e.g. in case of a Swiss letter box company which was not engaged in any ascertainable business in Switzerland and in case of a group captive insurance company which was incorporated and based in the Netherlands Antilles. The Court concluded that those companies could have a place of effective management in the Netherlands and therefore create a permanent establishment (see OECD - Studies in Taxation of Foreign Source Income, Controlled Foreign Company Legislation, 1996, page 15 and Footnote 4; Dutch Supreme Court, BNB 1989/142 and BNB 1985/302).

[56] For example Austria, Luxembourg and Switzerland do not have any CFC legislation. The Danish CFC legislation is focused on financial activities (see Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 37).

[57] According to paragraph 24 of the Commentary on Article 4 of the OECD-MTC the place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions.

[58] Especially in tax treaty cases with a tie-breaker rule which is based on Article 4 (3) of the OECD-MTC.

[59] See in this respect Sandler, Tax Treaties and Controlled Foreign Company Legislation, 1998, page 4; OECD - Studies in Taxation of Foreign Source Income, Controlled Foreign Company Legislation, 1996, pages 13 and 14.

seriously affect the treaty relations where the provisions are based on the OECD-MTC.[60] Overall, a residence test is not an appropriate method to target the deferral of tax on foreign source income but is rather a method which can be applied to clearly abusive structures in certain - in my opinion very limited - cases.

5.7.4. General Anti-Avoidance Rules

The problem with general anti-avoidance rules is - very simply - that they are too broad and general for targeting the particular issue of tax deferral. Similar to what was described with respect to the residence test it can be of importance in the obvious cases of abuse, e.g. letter box companies. However, the typical CFC case is - in my opinion - far from being abusive. What should be clear is that in a situation of a foreign company which is situated in a low-tax country and which carries on its business functions within the foreign territory and where the management decisions are actually taken in the respective foreign country, the only "abusive" behaviour lies in the fact that the foreign income is accumulated and not distributed to the parent company, and therefore kept away from domestic taxation. However, what makes it more complicated is the fact that the accumulation of income is normally not considered to be "abusive." Such a situation can hardly be targeted by broad and general anti-avoidance rules but requires more specific legislation.

5.7.5. Restriction on the Participation Exemption

In some cases, countries which generally apply the exemption method for dividend payments received from subsidiary companies switch - under certain circumstances - to the credit method[61] or even to a full taxation without credit. For example, in Germany a great number of the existing tax treaties contain "activity clauses" according to which certain foreign source income is taxed pursuant to the credit method instead of the exemption method. However, this is of particular interest for permanent establishments but not for dividend payments anymore.[62] In Belgium, the dividends-received deduction – which leads to a 95 percent exemption of dividends received from a qualifying subsidiary – can only be applied if the dividend paying company is not established in a country where the common tax regime is considerably more favourable than in Belgium.[63] Similar rules exist in Austria if the subsidiary derives passive income which is subject to low-taxation.[64]
In my opinion, those measures can only have limited influence on foreign passive investments. If the credit method on dividend payments is applied (or even taxation without a tax credit), the foreign passive investment in low-tax countries will be taxed as soon as the income is distributed to the resident shareholder. This is not the case where the dividend payment is exempt from taxation. That means, in order to take full advantage of the lower tax rates the profits have to be retained and reinvested by the

[60] See Article 4 (3) of the OECD-MTC.
[61] See in this respect also the recommendations included in the OECD Report on Harmful Tax Competition (Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraphs 104, 105).
[62] See Wassermeyer, Der Wirrwarr mit den Aktivitätsklauseln im deutschen Abkommensrecht, Internationales Steuerrecht 2000, page 65 et seq.; the activity clauses are of no particular relevance anymore in case of dividend payments, because dividend payments are generally exempt from domestic taxation according to section 8 b (1) of the German Corporate Income Tax Act.
[63] In addition, certain types of dividends are explicitly excluded from the dividends-received deduction. See in this respect Tahon / Bogaerts, Belgium: Amendments to the Participation Exemption Regime, Tax Planning International Review, December 2002.
[64] Section 10 (3) of the Austrian Corporate Income Tax Act.

foreign subsidiary company. This is clearly a restriction of the overall flexibility and therefore a disadvantage for the companies - compared to a situation where the profits can be repatriated free from additional taxation.[65] However, taxation which is limited to *actual* dividend payments does not target the *deferral* of domestic taxation on foreign source income and therefore the *time factor* involved. Especially international groups can structure their investments in a way which allows the permanent accumulation of foreign source income without any profit distribution to the shareholder. In particular, this is the case where the retained profits can be made available to other group companies (including the parent company), e.g. by way of inter-company loans. In my opinion, a switch-over from the exemption method to the credit method for actual dividend payments can lead to a limitation of flexibility, but it cannot be seen as a measure which fulfils the purpose of CFC taxation and, thus, cannot be considered a substitute for CFC rules.

5.7.6. Restriction on the Deduction of CFC-Related Business Expenses

Without any doubt, the restriction on the deduction of business expenses for payments to a CFC would act as a deterrent for resident taxpayers to use such a foreign company. However, such a restriction can - in my opinion - only be applied in very limited cases but not as a general method in order to safeguard the domestic tax base. Some countries disallow the deduction in a situation where a transaction with a tax haven takes place and the resident recipient of the services is not able to prove that the underlying services were actually carried out.[66] This, however, is something totally different compared to CFC taxation. It is a common principle that the taxpayer has to prove, or at least to make plausible, that the payments are business related and, therefore, have to be qualified as deductible business expenses. If this is not possible, the deduction of the payments as business expenses can be disallowed. However, a general restriction (which goes beyond the tax haven payments) would create serious problems under the existing tax treaties with the respective CFC country and would not be in line with the ability-to-pay principle.[67] It would basically lead to the outcome that positive income of the domestic taxpayer is taken into account and taxed in the resident country, but the deduction of business expenses related to the positive income is disallowed. Therefore, such an approach can hardly be seen as a feasible alternative to CFC taxation.[68]

5.7.7. Imposition of Withholding Taxes on CFC-Related Payments

The imposition of withholding taxes can make the investment in a low-tax country less attractive, especially in cases where the withholding tax cannot be fully credited against the corporate income tax imposed by the CFC country, e.g. where the

[65] For example, if the parent company suffers losses it can be more advantageous - and even necessary - to distribute the profits of the (low-tax) subsidiary to the parent company in order to reduce the interest payments (on third party loans and inter-company loans) and to improve the result of the parent company. However, if the credit method is applied to the profit distribution, the tax losses of the parent company will be reduced - with the effect that they cannot be offset against positive taxable income in subsequent years - and the crediting of taxes is not possible (due to the fact that no domestic income tax is paid in the respective year). The crediting of the taxes can finally be possible, however, if the respective legislation provides for a carry forward (“roll-over”) of the tax credit.

[66] E.g. Germany, Spain.

[67] See Article 24 (1), (4) of the OECD-MTC.

[68] It seems to be quite obvious that such an approach would be a clear infringement of the basic freedoms (in an EU context) which cannot be justified. Whether this is the case for the CFC rules will be outlined separately.

withholding tax is higher than the income tax of the CFC. This can be of particular relevance in non-treaty cases. However, if a tax treaty exists between the source country and the resident country of the CFC, the withholding tax rate will be applied to the respective payments without any active-passive differentiation and, therefore, irrespective of the activity of the CFC. Furthermore, a comparable effect can most often only be achieved where the withholding tax rate is equal to – or at least similar to – the domestic income tax rate of the source country.[69] This, however, is difficult to achieve in a tax treaty situation.[70]

In addition, it must be taken into account that a withholding tax is only applied to direct payment streams from the source country to the CFC country, i.e. payments from subsidiary companies abroad towards the low-tax country are not affected. In contrast to CFC taxation, there is no link whatsoever to the actual result of the foreign entity calculated according to the rules of the country which applies the CFC taxation. That means, irrespective of whether the CFC is highly profitable or in a loss position, the withholding tax deducted from the payment will be the same. The system is therefore completely different to CFC taxation.

5.7.8. Information Reporting Rules and Exchange of Information

The information reporting rules stipulated in the national legislation can help countries to obtain information about the foreign activities of their residents. At least, those rules provide a legal basis for the gathering of information with respect to foreign activities. The same is true for bilateral or multilateral exchange of information provisions (e.g. in double tax conventions or multilateral conventions) which are of particular importance in case of tax evasion, i.e. in cases where the resident taxpayer does not submit any information with respect to the foreign investment activities.[71] It is obvious that those provisions are a prerequisite for the proper application of CFC taxation and similar measures. However, it is equally obvious that those provisions cannot be more than a supporting element in the context of CFC taxation.

5.7.9. Conclusions Regarding the Alleged Alternative Measures for CFC Rules

It can be concluded that *none* of the measures outlined above can be considered a substitute for CFC rules. Some of the alleged alternative measures for CFC rules can in fact limit the advantage of foreign passive investments in low-tax countries (e.g. the general transfer pricing rules, the switch-over from the exemption method to the credit method, and the imposition of withholding taxes) and can create an obstacle to abusive investments (e.g. the residence test, the general anti-avoidance rules). However, none of the measures really targets the deferral of domestic taxation on foreign source income. In case of a non-abusive foreign investment, the profit which

[69] At least, this is true where the CFC is equity financed and without a significant amount of business expenses. The OECD Report on Harmful Tax Competition states that *"(…) the imposition of withholding taxes at a substantial rate on certain payments to countries that engage in harmful tax competition, if associated with measures aimed at preventing the use of conduit arrangements, would act as a deterrent for countries to engage in harmful tax competition and for taxpayers to use entities located in these countries*" (see Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 161).

[70] This would result in a factual non-taxation in the CFC country, because the ordinary tax credit would be equal to the income taxes imposed in the CFC country.

[71] See with respect to the recommendation for the adoption of domestic information reporting provisions and bilateral / multilateral exchange of information provisions: Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraphs 106-107 and paragraphs 114-117.

is related to the functions exercised and the risks taken by the foreign entity cannot be targeted by the aforementioned methods. However, the avoidance of deferral in exactly those cases is the purpose of CFC legislation.

5.8. CFC Rules and the Ability-To-Pay Principle

The question arises whether the CFC-specific feature of a current taxation of CFC income - without any actual dividend payment of the foreign entity - is a particular problem under the ability-to-pay principle. If the state of the resident shareholder treats an actual dividend payment in the same way as the attribution of CFC income, the main difference lies in the fact that in the latter case the income - and therefore the increase in value of assets of the foreign entity - is not made available to the shareholder by way of profit distribution. Of course, from an economic perspective this is an important difference since the underlying income is still subject to the risks of the market where it is invested and is not transferred to the resident shareholder. If the underlying income is distributed to the shareholder, the domestic taxes imposed by the state of residence can be paid out of the dividends received. In contrast thereto, the attribution of CFC income is just the result of an income calculation without a real transfer of financial means. In such a case, the resident shareholder in the CFC is not in the position to actually use part of the attributed income for the payment of the taxes imposed on the CFC income. Nonetheless, it is questionable whether the actual transfer of income - by way of profit distribution - is the decisive criterion for the decision whether the taxation is in line with the ability-to-pay principle or not. Some aspects have to be clarified in this respect.

a.) The legal form of the investment

The CFC taxation is applied to the investment in a foreign legal entity if certain requirements are fulfilled.[72] The shareholders in such a legal entity are not in a position to withdraw the investments in the same way as in case of a permanent establishment or partnership. In the latter case of a partnership, however, the procedure which is required for the withdrawal of financial means and the allocation and distribution of income depends on the respective legislation. It can be quite formal and similar to the procedure which is required in case of a corporate body, but there are also states which do not require any particular formality and which offer the possibility of stipulating the procedure in a partnership agreement. In the latter case, the partners are free to decide on the withdrawal of financial means. Thus, it may be the case that no formal decision whatsoever is necessary. This, of course, is different in case of a corporate body where the shareholders formally have to decide whether the legal entity distributes all or part of the profit to the shareholders or whether the profit is to be retained and carried forward. The percentage of shareholding or voting rights is therefore of great importance. If the investor has only a minority shareholding (minority voting rights) in the legal entity, he will not be in a position to influence a profit distribution. In contrast, if the investor has a majority shareholding (majority voting rights) in the legal entity, which is typically more than 50 percent, he will be in a position to influence a profit distribution also against the will of other (minority) shareholders. In the latter case of a majority shareholding (majority voting rights) the position of the

[72] Some countries also apply their CFC taxation to permanent establishments and partnerships (see below in more detail).

shareholder is - in my opinion - not substantially different to a partnership interest. Of course, the fact that the income is derived by a corporate body requires the formal decision upon the profit distribution - and therefore additional steps compared to the investment in a partnership - but it is solely in the hands of the majority shareholder to decide whether the profit is to be distributed to the shareholders or retained on the corporate level.

b.) The increase in value of the investment

Irrespective of a majority or minority shareholding in the foreign entity, it is important to verify whether (i) it is the increase of the (legal) net equity of the foreign entity, (ii) the increase in value of the shares, or (iii) the increase in value of the assets held by the foreign entity which is decisive and sufficient to justify the current taxation of CFC income.

The differentiation is important because the increase of the net equity of the foreign entity is not necessarily equal to the income attribution to the shareholder. The reason is that in most cases the amount of attributed income is calculated pursuant to the rules of the state which applies its CFC taxation.[73] This can lead to temporary and even permanent differences between the income allocation and the amount which can (legally) be distributed by the foreign entity. Similar aspects apply to the increase in value of the shares. The accumulation of CFC income can only lead to a corresponding increase in the value of the shares if the activity of the CFC does not result in the creation of additional (hidden) values which do not (yet) have an effect on the actual income. For example, if the investment of the CFC is mainly limited to the investment in a short-term bond, and the interest rate is in line with the market rates, the interest income will lead to a more or less comparable increase in the value of the shares in the CFC. Here, the return on investment in the bond and in the shares are comparable. However, this can be different where the activities of the CFC are more complex (e.g. base company activities) or where the CFC income is dependent on the (future) result of other companies which cannot be clearly stipulated in advance but which are solely dependent on the success of future activities. For example, if the CFC is the owner of patent rights which lead to royalty income from the licensing out of those rights to other companies, and the royalties are solely dependent on the sales of the foreign companies, the value of the activities (and therefore the value of the shares) is mainly dependent on expectations. Here, the increase (or decrease) of sales is decisive and therefore the discounted cash-flows which can be derived in the future. The increase in value of the shares will not be equal to the profit which is derived in one single year but will be influenced by changes in the expectations of future earnings (respectively cash-flows).

Thus, the amount of income attribution is in most cases not dependent on the legal results of the foreign company and the increase of the (legal) net equity. The increase in value of the shares is not directly connected to the income attribution, either. In my opinion, the focus must be on the respective investment of the CFC itself. For example, a given amount of interest income can be derived directly by the shareholder or indirectly through the CFC. In the

[73] See Arnold / Dibout, Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 58.

first case, the shareholder receives the interest payment directly - for example - on a yearly basis. In the second case, the interest proceeds are derived by the CFC and only indirectly by the shareholder. Nonetheless, the amount of interest income is now part of the property held by the shareholder. In my opinion, this is irrespective of the fact whether the amount of interest income is calculated in the same way and according to the same methods in both countries - the residence state of the shareholder and the state of the CFC - and whether the interest income finds expression in exactly the same amount in the legal net equity of the foreign company or the share value. Clearly, this can lead to a deviation between attributable income and subsequent dividend payments of the CFC. Leaving aside the question whether the interest income can actually be "used" by the shareholder or whether it is locked-in in the foreign entity (see above), it must be concluded that there is an increase in value of the property - from the perspective of the country of the shareholder - which can either be in the form of an increase of the financial means of the shareholder, through the direct interest payment, or in the form of an indirect increase of the property held by the foreign entity.

c.) The different approaches under the CFC regimes

In general, the countries which apply a CFC taxation follow two different approaches: the entity approach and the transactional approach.[74] The entity approach can be described as an "all-or-nothing" approach, i.e. either the whole income of the CFC is attributed to the resident shareholder or it is completely excluded from CFC taxation. The transactional approach is focused on certain - tainted - income, i.e. only tainted income is attributed to the resident shareholder.[75] Again, the income is in most cases calculated according to the rules of the country which applies the CFC taxation.[76] It is very clear that the transactional approach can lead to additional deviations from the income based on the commercial accounts of the foreign company. For example, this can be the case where the CFC carries out an activity which is excluded from CFC taxation and which leads to negative income (active income) and, in addition, an activity which is subject to CFC taxation and which leads to positive tainted income. It is important to recognise that the tainted income is still positive and therefore increases the property of the shareholder, although the net equity based on the commercial accounts of the foreign company is negative and a profit distribution is - pursuant to the laws of the foreign country - not possible. This conclusion is based on the principle that the focus must be on the investments of the CFC and the respective income components and not on the income based on the commercial accounts of the foreign entity itself. In fact, the latter income can be seen as irrelevant for CFC legislation.

If we accept hat the CFC income leads to an increase in value of the property of the shareholder and that the income has to be seen unconnected from the foreign legal entity, the question remains whether the fact that the shareholder does not have

[74] See Arnold / Dibout, Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 49, 50.
[75] I will go into more detail of the entity approach and the transactional approach below.
[76] In general, this is equally true for countries which follow an entity approach and countries which follow a transactional approach.

immediate access to the foreign income is of particular relevance in this context. However, even if the shareholder has a majority shareholding (majority voting rights) in the foreign entity, it is not self-evident that the dividend payment is equal to the attributed CFC income. In the worst case, the majority shareholder will not be in a position to decide a distribution of profit if the income based on the commercial accounts of the CFC is negative. This can be due to different business activities carried on by the CFC (see above). In case of a minority shareholding, the shareholder has no possibility to influence a profit distribution or a liquidation of the company. In such a case, the income derived by the CFC can be locked-in for many years, and the only possibility for the shareholder to receive liquid funds is the disposal of the shares. Nevertheless, I do not think that this is the decisive criterion. For example, if a taxpayer receives interest income from an investment in bonds but the proceeds are not transferred to the taxpayer but to the bank - because the taxpayer is indebted and therefore obliged to transfer all financial income to the bank - nobody will seriously question the fact that the interest income is nonetheless taxed in the hands of the taxpayer, even though the taxpayer does not have any possibility to pay the income taxes out of the income received.[77] The situation in case of an investment in a CFC is similar to the example: the taxpayer can freely decide to structure his investments in a way that the income is not derived directly by the taxpayer but indirectly through the investment in a foreign entity. This can have the effect that the income which is directly earned by the CFC (and indirectly by the shareholder) is not immediately available. Again, the conclusion from an economic point of view can be different. However, it is quite clear that the property of the taxpayer is increased at the very moment where the CFC receives the actual interest payment from its investments. In my opinion, the ability-to-pay principle cannot be narrowed and limited to a principle which requires the taxpayer to have the income "in his hands." I generally agree with the 1987 OECD-report on base companies which stated that the base company income *"(...) improved the ability of the shareholder to pay taxes because economically the income is at his disposal, thus constituting a capital yield of a special nature."* [78] Even though the income is included in the CFC - and therefore locked-in - it is important to recognise that the property is increased and the income is *economically* at the disposal of the shareholder, which does not necessarily mean that the income can be distributed by the entity. This does not mean that it is economically required to tax income on a current basis, either. The question whether the shareholding is a majority or minority shareholding is therefore not really decisive, because in both cases the property is increased by the income derived by the CFC, and the fact that the majority shareholder has easier access to the retained earnings and can influence the decisions of the company is not - in my opinion - the prevailing criterion in the context of the ability-to-pay principle. Thus, I do not think that – from a mere ability-to-pay point of view – there is any necessity for a complete sheltering of foreign income from domestic taxation until a decision is made to distribute income by way of dividend payment, disposal of the shares or liquidation of the company.[79]

---

[77] In the example, it is assumed that the bank loan is not connected to the investment in the bonds.

[78] Double Taxation Conventions and the Use of Base Companies, in International Tax Avoidance and Evasion - Four Related Studies, Issues of International Taxation (OECD 1987).

[79] Pursuant to Fleming / Peroni / Shay, the *"(…) deferral privilege is fundamentally inconsistent with the ability-to-pay principle and, therefore, fundamentally inconsistent with an income tax system based on the ability-to-pay norm."* (Fleming / Peroni / Shay, Fairness In International Taxation: The Ability-To-Pay Case For Taxing Worldwide Income, Florida Tax Review, Volume 5 (2001), page 340.

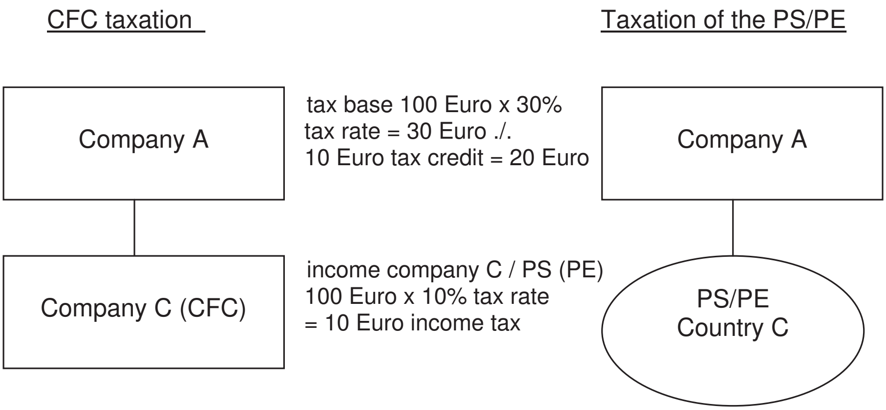
What is more important with respect to the ability-to-pay principle is the question of a clear separation of the activities of the CFC. Only the net result of a separable activity can be allocated to the resident shareholder.[80] If the activity itself cannot be separated, the partial allocation of positive income - even though the net result of the whole activity is negative - is certainly not in line with the ability-to-pay principle. Similar aspects are relevant in case of subsequent losses. If the positive income is attributed to the resident shareholder, it is equally required - in my opinion - to take into account the negative result of the same activity in subsequent years. A strict limitation to positive income would certainly not be in line with the ability-to-pay principle. Another aspect seems to be important: the attribution of positive CFC income includes the profit related to the functions and risks which are connected to the respective activity. From an economic perspective it is – in my opinion – very clear that an attribution of positive income requires in the same way the attribution of negative income. Again, the same is true from the perspective of the ability-to-pay principle. It cannot be acceptable from a tax policy point of view to tax the positive foreign income together with the positive domestic income but to separate the negative foreign income and to disallow - legally or factually - the offsetting with positive domestic income. If a tax system wants to exclude the negative income from the domestic tax base, the CFC regime has to be structured in a different way. In such a case, the attribution has to be limited to a risk-free interest rate of capital and cannot encompass any risk component whatsoever. Otherwise, the positive increase in value of the property is taken into account but not - in the same way - the decrease in value caused by the risks involved in the foreign activities and the respective markets.

5.9. CFC Rules and the Taxation of Permanent Establishments and Partnerships

CFC taxation is typically applied to foreign legal entities if certain requirements are fulfilled. Of course, the fact that those legal entities are non-transparent for tax purposes offers – in the absence of a CFC taxation – the possibility to defer the domestic taxation on foreign source income. It is therefore quite clear that non-transparent entities which are theoretically able to shelter the foreign source income from domestic taxation are the main target of CFC rules and similar anti-avoidance measures. However, if all other legal aspects and differences between partnerships (PS) and corporations – apart from the technical aspects of taxation – are put aside, it becomes quite obvious that the CFC taxation and the taxation of partnerships – pursuant to the credit system – can be identical.[81] The same is true for the taxation of permanent establishments (PE). Thus, if it is not otherwise explicitly stated in the following, the comments which are related to partnerships are equally true for permanent establishments.[82]

[80] The net result has to be seen as the gross income minus the expenses related to each of the separate activities.
[81] Under the assumption that the complete income is taken into account.
[82] A partnership interest is typically considered to be a permanent establishment of the partner in the other state.

Figure 1:



The overall tax burden is in both cases 30 percent, i.e. the income cannot be sheltered by the CFC and it is immediately taken into account in case of a PS/PE, too.[83] Obviously, there are serious legal differences: the CFC is a separate legal person and a separate taxpayer who is resident in country C, whereas the profit share of the PS/PE is legally allocable to company A. For tax purposes, the profit derived in country C is in both cases subject to tax in country C, but the person who is subject to tax is different.[84] This is a quite important difference from a tax treaty point of view and I will go into more detail of that aspect below in the context of the tax treaty provisions.

Obviously, the exemption of PS/PE income can have the same effect as the non-application of CFC taxation to the income derived by a foreign entity. That means, if passive income is derived by a PS/PE and the exemption method is applied, the income taxation is limited to the country of the PS/PE (and perhaps a third country - in case of withholding taxes).[85] This opens the possibility for a repatriation of foreign income without any additional income taxation.[86] At first glance, it seems necessary that a country which applies a CFC taxation to legal entities requires a comparable system for transparent partnerships and permanent establishments - in case the income is not taxed according to the credit method anyway.[87] In fact, some of the countries apply their CFC taxation to legal entities and PS/PE.[88] Other countries switch from the exemption method to the credit method if certain passive income is derived by the PS/PE.[89] Obviously, those countries see the necessity to apply anti-

[83] The income is calculated and taxed according to the systems of both countries, A and C.
[84] Under the assumption that the tax treaty between country A and country C is drafted along the lines of the OECD-MTC (Article 7 (1) of the OECD-MTC, Article 4 of the OECD-MTC).
[85] This may be different in case of an individual investor where the profit of the PS/PE (which is exempt from taxation) is taken into account for the determination of the domestic tax rate.
[86] At least, in most countries there is no taxation on the actual repatriation of PS/PE income.
[87] Like - for example - in the United Kingdom.
[88] For example France. The Italian rules apply to PS/PE of a foreign company (see in more detail below).
[89] For example the activity clauses in the German tax treaties and section 2 a of the German Income Tax Act (see in more detail below).

avoidance measures in case of non-transparent legal entities, transparent partnerships and permanent establishments.

However, there is an additional aspect which is of importance for the differentiation: the question of ownership of passive property - and therefore the question of income allocation for tax purposes - is quite clear in case of a foreign legal entity. The rights, receivables, shares, movable and immovable assets etc. which are held by the foreign entity are allocable to the foreign entity - unless there are certain other reasons according to which the structure has to be considered abusive. However, if it is assumed that the assets are managed by the foreign entity from within the foreign jurisdiction there is typically no basis for a different outcome. Thus, the beneficial and legal owner of the underlying income is the foreign entity. In order to tax the foreign income on a current basis, the residence state of the shareholder has to apply a specific tax regime in order to pierce the veil or to calculate a deemed dividend of the foreign legal entity.[90]

This is not equally true in case of a permanent establishment and a transparent partnership, even though a differentiation between PE and PS is now required. In case of a PE, the decision whether the passive property is allocable to the head office or to the PE cannot be made on the same basis as in case of a legal entity. Both, head office and PE, are part of a single legal entity and it is therefore not immediately obvious whether the passive property (and therefore the respective income) is allocable to the head office or the foreign PE. In this respect, it is important to clarify the following questions:

a.) Is it possible for a company to create a PE in another state by carrying on passive activities only?

The Commentary to the OECD-MTC states in this respect that *"(w)here tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business."* [91] It is important to recognise that the OECD refers to property which is let or leased to *third parties*. Clearly, the typical inter-company services do not encompass third parties but are solely limited to group companies. However, the functions exercised in the other state can be identical for third parties and related parties. Moreover, to a large extent activities can be subject to CFC taxation (and are therefore considered to be passive activities) even if the recipient of the services is a third party.[92] Thus, it seems that, in general, a permanent establishment does not necessarily require the exercising of active business activities but can equally be created by passive business activities – in case the activity is not of a preparatory or

[90] The different approaches will be discussed below in more detail. See in this respect Menck, Rechtsmechanismus und Rechtscharakter der Zugriffsbesteuerung, Deutsche Steuer-Zeitung, Ausgabe A, 1978, page 106 et seq.
[91] Paragraph 8 of the Commentary to the OECD-MTC on Article 5. See in this respect also Görl in Vogel / Lehner, Doppelbesteuerungsabkommen, Article 5, paragraph 25.
[92] See in more detail below.

auxiliary character.[93] However, even if the carrying on of passive business activities can lead to a PE, the question of an appropriate profit allocation as well as the allocation of the underlying assets remains.

b.) How much of the overall profit related to the passive activity is allocable to the PE?

Based on Article 7 (1) of the OECD-MTC, the profits of an enterprise may be taxed in the state of the permanent establishment, but only so much of them as is attributable to that permanent establishment. Article 7 (2) of the OECD-MTC states that *"(...) there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."* Thus, the income which is connected to the activity of the permanent establishment should be taxed in the state of the permanent establishment. In principle, it is not decisive in this respect whether the activity is an active business activity or a passive business activity. The property which is effectively connected to such an income-producing business activity in the PE state should, in general, also be allocable to the latter state. In other words, a functional allocation of income and property has to be made between PE and head office.[94]

However, it might be interesting to have a look at the German concept of what is called *the central function of the head office,*[95] because it reveals a restrictive approach which can be of particular relevance in case of passive investments and intra-group activities. Based on the German concept the property either has to be allocated to the PE or to the head office.[96] In principle, the allocation is dependent on the respective functions carried out by the PE and the head office. A partial allocation is not possible.[97] If assets are used in different parts of the entity (including PE), the decision of the management shall be decisive.[98] However, for some types of property there is a compulsory allocation to the head office which is based on the German concept of the central function of the head office. According to this German concept shares in subsidiary companies, financial means and intangible property can only be allocated to the PE if they are directly connected to - and necessary for - an activity which is carried out by the PE itself (but which is not

[93] Article 5 (4) of the OECD-MTC.
[94] See in this respect Wassermeyer in Debatin / Wassermeyer, Doppelbesteuerung, Article 7, paragraph 240.
[95] See with respect to the approach of the German tax authorities to the central function of the head office ("Zentralfunktion des Stammhauses"): Circular of the Ministry of Finance, dated December 24, 1999, BMF IV B 4 – S 1300 – 111/99, BStBl. I 1999, page 1076 ("*Betriebsstätten-Verwaltungsgrundsätze*" - German Administrative Principles for Permanent Establishments). It seems that Switzerland is following a similar concept ("Zentralverwaltung"). See in this respect Locher, Die Praxis der Bundessteuern, III. Teil: Das interkantonale Doppelbesteuerungsrecht (February 2007), § 8, II, B, 2d, no. 2; Kessler / Jehl, Kritische Analyse der Zentralfunktion des Stammhauses, Internationale Wirtschafts-Briefe 2007, page 1977 et seq. (1984); Baumhoff / Leitner / Digeronimo, Betriebsstättengewinnermittlung im internationalen Vergleich - Deutschland, Österreich, Schweiz, Internationale Wirtschafts-Briefe 2000, page 1433.
[96] See 2.4. of the German Administrative Principles for Permanent Establishments.
[97] See 2.4. of the German Administrative Principles for Permanent Establishments.
[98] See 2.4. of the German Administrative Principles for Permanent Establishments; German Supreme Tax Court (BFH), April 1, 1987, BStBl. 1987 II page 550.

a holding, financing or licensing activity).[99] In essence, this has the effect that there is a major difference if the holding functions, group-financing functions and licensing functions are carried out by a PE instead of a separate legal entity. Pursuant to the German approach the property which is related to the aforementioned functions will not be allocated to the PE and, what is very important in this respect, the income allocated to the PE will be limited to a (service) fee for the "handling" of the activities.[100] In other words, the German approach does not accept, for example, the allocation of the total amount of interest income realised from intra-group financing activities (e.g. with group companies in other countries) to the PE state, but restricts the allocable income to the coordination and the handling of the financing activities. The latter, of course, will often have the effect that the income of the PE is substantially lower than in a situation in which the full amount of interest income is allocable to the PE. Therefore, such an approach makes it impossible to transfer property and income with respect to certain types of passive investments and intra-group activities to a PE.[101] The German approach is clearly not in line with the OECD principles, as described above, which provide for an unrestricted functional allocation of property and income. The OECD approach is - in my opinion as well - the appropriate approach since I do not see any justification for such a limitation of the functional allocation. In the end, it will most certainly increase the number of mutual agreement procedures and arbitration procedures.

c.) Is the outcome different if the PE carries on active and passive activities?

The question arises whether the German approach described above leads to a different outcome in case the PE carries on as its main activity an active business and, in addition to that, a passive business activity. In this regard, the German concept of the central function of the head office will be equally relevant and still requires the compulsory allocation of certain property (and therefore also income) to the head office. The combination of active and passive activities in the PE, therefore, does not result in a different conclusion. As already described above, it is clear that such an approach is not in line with OECD principles and should, in my opinion, clearly be rejected.

Similar aspects apply to the income derived by a PS. However, in contrast to the PE, the PS often has an economic personality of its own and can be – depending on the respective country and the type of PS – the legal owner of the property purchased. Of course, this should – in general – not lead to a different outcome for tax purposes compared to the principles applied in case of a PE. However, the PS concept is different from country to country and classification conflicts can come up where, for example, the state of the PS considers the PS to be non-transparent, whereas the residence state of the partners treats the PS as transparent for tax purposes – and vice versa. For example, the Spanish *Sociedad Comanditaria* is a limited PS

[99] See 2.4. of the German Administrative Principles for Permanent Establishments; see in this respect also the German Supreme Tax Court (BFH), August 30, 1995, BStBl. 1996 II page 563.
[100] See 4.4.3 of the German Administrative Principles for Permanent Establishments.
[101] According to Kessler / Jehl it is "factually forbidden" under the German concept to carry out financing functions, holding functions and licensing functions through a PE (Kessler / Jehl, Kritische Analyse der Zentralfunktion des Stammhauses, Internationale Wirtschafts-Briefe 2007, page 1977 et seq. (1980).

according to Spanish law.[102] For Spanish tax purposes, the PS is treated as non-transparent and the income is subject to Spanish corporate income tax.[103] From a German perspective, the *Sociedad Comanditaria* is considered a transparent PS, with the effect, that the income is allocable to the partners, i.e. the PS interest is seen as a permanent establishment of the German partners in Spain. If the Spanish limited PS purchases passive property like patent rights and movable assets for the licensing and renting out to other (group) companies, or uses the financial means received from the partners to start inter-company financing activities, this can lead to a conflict between the Spanish and the German tax authorities. The Spanish tax authorities would most certainly treat the passive property and the income derived from the passive property as taxable income of the limited PS in Spain, whereas the German tax authorities would have to deal with the question whether the property (and the respective income) is allocable to the Spanish PS[104] or whether it is allocable to the domestic property of the German partners and therefore taxable in Germany. Clearly, this is more complicated than in a regular PE situation and – very often – such a dispute has to be solved by way of a mutual agreement procedure.[105]

The allocation of property and passive income is therefore comparable in case of a PS and a PE. It can be concluded that the shifting of passive income to a PS/PE is much more restricted and it cannot be shifted to the same extent as in case of a foreign legal entity. This is due to the fact that the general income allocation principles have to be applied first and irrespective of the subsequent question of an avoidance of double taxation according to the credit method or the exemption method. However, the classification (or qualification) conflicts cannot be solved by income allocation rules. The fact that - for example - the PS state considers the PS to be non-transparent for tax purposes makes the whole situation comparable to the treatment of a CFC, i.e. a foreign legal entity. Such a classification of the PS state shelters the active and passive income from taxation in the residence state of the partners if the PS income is generally exempt from taxation. In such a case, only the application of the credit method ensures the taxation of passive income which would otherwise be allocable to the residence state of the partners.

The OECD Partnership Report deals in detail with the classification conflicts related to partnerships.[106] In the relevant situation outlined above, i.e. where the PS is treated as a taxable entity in the state of the PS and as transparent entity in the residence state of the partners, the majority of the participating countries made a general distinction which is related to the source of income: if the income (e.g. royalty income) of the PS is derived from sources within the PS state, it involves a purely domestic matter of the PS state and it simply taxes the domestic source royalty income of a resident taxpayer and nothing in the Convention can limit that right. The fact that double taxation results because of the differing income allocations of the two

[102] Article 122 no. 2 of the Spanish Trade Law.
[103] The Application of the OECD Model Tax Convention to Partnerships, Issues In International Taxation (OECD 1999), page 116; Article 7 (1) of the Spanish Corporate Income Tax Act.
[104] Which is, in effect, a PE of the German partners in Spain.
[105] In this particular example, the Spanish-German tax treaty contains an activity clause which should be applicable to the PS income (see the German Ministry of Finance, circular dated May 28, 1998, BStBl. I 1998, page 557). Therefore, if the respective income is passive in the sense of the activity clause, the credit method will be applied. Nonetheless, Spain is a high-tax country and it is, of course, a different result from a German perspective if the income is directly allocable to the German partners without a taxing right for Spain.
[106] The Application of the OECD Model Tax Convention to Partnerships, Issues In International Taxation (OECD 1999).

states is - based on the view of the majority countries - not a reason to limit the right of the PS state to tax its residents.[107] Only a minority of delegates followed the principle that the PS state should refrain from taxing the income and leave the exclusive taxing right with the residence state of the partners.[108] Due to the fact that the latter state allocates the royalty income directly to the resident partners - since the royalty income is not allocable to a PE in the PS state - a double taxation would occur and could only be avoided if the residence state of the partners allowed the crediting of the foreign taxes levied in the PS state. The situation of royalty income derived in a third country does not lead to a substantially different outcome: the PS state would tax the royalty income based on the tax treaty concluded with the source state. The PS state clearly allocates the royalty income to the PS which is considered to be non-transparent for tax purposes. Although the source state and the PS state should take into consideration the treatment of the income in the residence state of the partners, this would not lead to the result that the PS state refrains from taxing the royalty income. With respect to the situation where the royalty income has its source in the residence state of the partners, the majority of the delegates took the position that the royalty income may be taxed in the residence state of the partners, but should give relief for a taxation of the income in the PS state.[109]

5.10. Harmful Tax Competition - The OECD and EU Approach

5.10.1. The OECD Report on Harmful Tax Competition

The OECD published its Report "Harmful Tax Competition - An Emerging Global Issue" in 1998 based on the initiative of OECD Ministers in 1996 to "*develop measures to counter the distorting effects on harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998.*"[110] Progress Reports were issued in order to provide updated information on the harmful tax practices work.[111] In general, it has been recognised that in a world of accelerating globalisation specific tax schemes which are aimed at attracting financial and other "*geographically mobile activities*" can create harmful tax competition between states and, consequently, can lead to the erosion of national tax bases.[112] Therefore, the Report is focused on mobile activities, such as financial and other service activities, including the provision of intangibles, but leaves out tax incentives designed to attract investment in plant, building and equipment.[113] However, it must be clearly stated that the Report does not deal with low-tax countries as such, because tax competition and the reduction of tax rates are, in general, considered to be positive. According to the OECD, low tax rates can be "*welfare enhancing where it is the outcome of a fair competitive process.*"[114] The

[107] Paragraph 131 of the OECD Partnership Report.
[108] Paragraph 132 of the OECD Partnership Report.
[109] Paragraph 127 of the OECD Partnership Report.
[110] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), page 3 (Foreword) and page 7 (Introduction).
[111] The OECD's Project on Harmful Tax Practices: The 2004 Progress Report, (OECD 2004); The OECD's Project on Harmful Tax Practices: The 2001 Progress Report, (OECD 2001); The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries (OECD 2006).
[112] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 2.
[113] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 6.
[114] The OECD's Project on Harmful Tax Practices - A Briefing Note for Journalists, (OECD 2004) paragraph 2.

focus of the Report are tax-haven jurisdictions and harmful preferential tax regimes in non-tax-haven jurisdictions.[115]

a.) Tax-haven jurisdictions

Based on the Report, tax havens serve three main purposes: "*they provide a location for holding passive investments ("money boxes"); they provide a location where "paper" profits can be booked; and they enable the affairs of taxpayers, particularly their bank accounts, to be effectively shielded from scrutiny by tax authorities of other countries*."[116] There are certain key factors for identifying tax-haven jurisdictions which can be summarised as follows: (i) no or only nominal taxation of the relevant income,[117] (ii) the lack of effective exchange of information, (iii) the lack of transparency, and (iv) no substantial activities in the respective jurisdiction, i.e. there is little real activity in the host country.[118] In any case, the non-taxation or only nominal taxation is a necessary condition for the identification of a tax haven.[119]

b.) Harmful preferential tax regimes

Harmful preferential tax regimes are established to attract those economic activities which can most easily be shifted from one country to another, i.e. typically base company activities and other passive investments. The key factors to identify a harmful preferential tax regime are similar to those outlined above with respect to tax-havens: (i) a low or zero effective tax rate on the relevant income, (ii) the "ring fencing" of the regimes,[120] (iii) the lack of effective exchange of information, and (iv) the lack of transparency.[121] Comparable to the tax havens, a harmful preferential tax regime will be characterised by a combination of a low or zero effective tax rate and one or more of the other key factors.[122]

It seems to be quite obvious that both, the tax-haven jurisdictions and the harmful preferential tax regimes, can create a serious risk of tax base erosion, especially for high-tax countries. For this reason, the Report provided several recommendations of counteracting measures against harmful tax competition which are divided into the following three categories: (i) recommendations concerning domestic legislation and practices, (ii) recommendations concerning tax treaties, and (iii) recommendations to intensify international co-operation in response to harmful tax competition.[123] It is not surprising, in my opinion, that the recommendations concerning domestic legislation

[115] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 38; see also Eimermann, OECD-Arbeiten zum schädlichen Steuerwettbewerb - ein Zwischenstand, Internationales Steuerrecht 2001, page 81 et seq.
[116] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 49.
[117] This is certainly one of the main features of a tax-haven and the feature which is responsible for its attractiveness from the perspective of multinational enterprises.
[118] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraphs 47-56.
[119] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 52.
[120] Some preferential tax regimes are partly or fully insulated from the domestic markets of the country providing the regime.
[121] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraphs 57-67.
[122] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 59.
[123] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 92; see also the summary of the recommendations in the Appendix "Recommendations And Guidelines For Dealing With Harmful Tax Practices."

include the introduction of CFC and FIF rules. It is explicitly stated with respect to CFC rules that "*countries that do not have such rules consider adopting them and that countries that have such rules ensure that they apply in a fashion consistent with the desirability of curbing harmful tax practices*."[124] The Report concluded that CFC rules are *"(…) an effective tool to deal with harmful tax practices. However, their effectiveness is reduced by the fact that they are not applied by all countries and even in those countries that do apply them, they do not cover all situations of harmful tax practices*."[125] Moreover, it is stated that *"(w)hile the Recommendation only applies in the context of curbing harmful tax practices, CFC rules may also apply in situations which do not involve harmful tax practices as defined in this Report. It is recognised that countries retain their right to use such rules in such situations*."[126] However, the Report does not see - due to the different domestic tax systems - a basis for the harmonisation of CFC rules or the development of model CFC provisions, but proposes that the *"(...) greater co-ordination in targeting such domestic rules will be a useful improvement. Accordingly, Member countries are urged, with the continued co-ordination by the OECD, to try for congruence of results of their respective CFC or equivalent legislation in a manner consistent with the objectives of this Report. Further work may enable the Committee to elaborate on some minimum standards for the design of such regimes in terms of their effectiveness in counteracting harmful tax practices*."[127] Comparable recommendations were given with respect to FIF rules, and *"(...) countries that do not have FIF or equivalent rules are asked to consider adopting such rules*."[128] I will not go into detail of the other recommendations since they are either not comparably important for the study or discussed separately in the context of alleged alternative measures for CFC taxation.

It is very clear from the Report that low-taxation (or even zero-taxation) is the basic condition for a tax haven or a harmful preferential tax regime. One could hardly imagine a tax haven with a high tax rate. Especially for multinational companies it is - from my perspective - not the lack of transparency or the lack of effective exchange of information which is the important element but the reduction of the overall effective tax rate.[129] The non-co-operation of a tax-haven jurisdiction may therefore be an important element for investors who have something to hide, but not - in general - for multinational enterprises which intent to relocate passive activities to other countries and which have to fulfil legal reporting obligations.[130]

However, from the more recent developments and OECD publications it can be understood that changes are taking place in the focus of the project on harmful tax competition. Instead of focusing on tax haven jurisdictions and harmful preferential tax regimes, the principle of transparency and the effective exchange of information play a more and more important role to achieve a "global level playing field."[131] Of course, there is still a differentiation between co-operative and non-co-operative jurisdictions, but the criterion of "no or low taxation" is less visible. In the 2006

[124] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraphs 97-100.
[125] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 98.
[126] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 98.
[127] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 100.
[128] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraphs 101-103.
[129] Of course, this may be different in case of financial institutions with respect to their customers.
[130] E.g. reporting requirements towards the headquarter jurisdiction / shareholders.
[131] A Process for Achieving a Global Level Playing Field, OECD Global Forum on Taxation, Berlin, 3-4 June 2004 (OECD 2004); Progress Towards a Level Playing Field: Outcomes of the OECD Global Forum on Taxation, Melbourne, 15-16 November 2005 (OECD 2005).

Progress Report it was made clear that the latter criterion is used "*merely as a gateway criterion to determine those situations in which an analysis of the other criteria is necessary. The adoption of a low or zero tax rate by itself is never sufficient to identify a preferential tax regime as harmful*."[132] The 2006 Progress Report states that "*by promoting the implementation of the principles of transparency and effective exchange of information, OECD countries seek to enable each country to retain sovereignty over national matters and to apply effectively its own tax laws. The decision on the appropriate rate of tax is a sovereign decision of each country. OECD member countries do not seek to dictate to any country (...) what its tax rate should be or how its tax system should be structured*."[133]

5.10.2. The EU Code of Conduct for Business Taxation

In 1997 the ECOFIN Council[134] adopted a resolution on a Code of Conduct for business taxation in the European Union.[135] The Code of Conduct is part of a "*package to tackle harmful tax competition in the European Union*" which encompasses also the taxation of savings income and the issue of withholding taxes on cross-border interest and royalty payments between companies.[136] When adopting the Code, the Council, acknowledged "*the positive effects of fair competition and the need to consolidate the competitiveness of the European Union and the Member States at international level, whilst noting that tax competition may also lead to tax measures with harmful effects*." The Code of Conduct for business taxation is therefore designed "*to curb harmful tax measures*" which unduly affect, or may affect, "*in a significant way the location of business activity in the Community*."[137] It was made clear that "business activity" in this respect also includes the activities carried out within a group of companies.[138] Moreover, the Code explicitly outlined that *"(...) tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful (...). Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor*."[139] Similar to the OECD Report on Harmful Tax Competition, the Code of Conduct describes certain key factors which are of importance and which should be taken into account for the identification of harmful tax measures. The criteria for identifying potentially harmful measures include: (i) the limitation of advantages to non-residents or in respect to transactions carried out with non-residents, (ii) the ring-fencing of the respective regime, (iii) the granting of advantages without any real economic activity and substantial economic presence within the respective Member State, (iv) the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD, and (v) the lack of transparency.[140] The Code of Conduct requires Member

[132] The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries (OECD 2006), page 3, footnote 4.
[133] The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries (OECD 2006), paragraph 6.
[134] The Council of Economics and Finance Ministers (ECOFIN).
[135] Conclusions of the ECOFIN Council Meeting concerning taxation policy (98/C 2/01), December 1, 1997.
[136] See also van Mens / Porquet, European Union - Current Tax Issues, European Taxation 2001, page 335 et seq.
[137] Code of Conduct for business taxation, paragraph A.
[138] Code of Conduct for business taxation, paragraph A.
[139] Code of Conduct for business taxation, paragraph B.
[140] Code of Conduct for business taxation, paragraph B.

States to refrain from introducing any new harmful tax measures ("standstill") and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code ("rollback").[141] Regarding tax avoidance and tax evasion, the Council notes that *"anti-abuse provisions or countermeasures contained in tax laws and in double taxation conventions play a fundamental role in counteracting tax avoidance and tax evasion*."[142]

In order to assess the tax measures of the Member States a Code of Conduct Group was established (the so-called Primarolo Group).[143] On November 29, 1999, the Group presented its report on harmful tax regimes within the Member States and their dependent or associated territories.[144] The Report adopted a classification of harmful measures into six categories: (i) financial services, group financing and royalty payments, (ii) insurance, reinsurance and captive insurance, (iii) intra-group services, (iv) holding companies, (v) exempt and offshore companies, (vi) miscellaneous measures. However, most of the systems listed in the Report can be placed into one of two categories: (i) systems applying to "intra-group" service companies and holdings, covering three kinds of enterprises, headquarters or co-ordination centres, service centres and distribution centres; and (ii) systems applying to financial services companies and "offshore" companies. In principle, all these systems primarily benefit multinational companies belonging to non-residents.[145]

5.10.3. The Main Differences between the OECD Report on Harmful Tax Competition and the EU Code of Conduct

The OECD Report and the EU Code of Conduct are to a large extent overlapping, especially with respect to the criteria set out for the identification of preferential tax regimes. Nonetheless, there are important differences which should be noted.[146]

a.) Both, the 1998 OECD Report and the EU Code of Conduct, are focused on preferential tax regimes which offer a low-taxation of income (or even zero taxation) *and* which are not generally applicable to all resident and non-resident taxpayers (ring-fencing). However, the OECD Report made an additional differentiation between preferential tax regimes and tax havens, whereas the Code of Conduct only stipulated that *"(...) tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code*."[147] However, from the recent developments and OECD

[141] Code of Conduct for business taxation, paragraphs C and D.
[142] Code of Conduct for business taxation, paragraph L.
[143] Based on paragraph H of the Code of Conduct. The Code of Conduct Group (Business Taxation) was established at a Council meeting on March 9, 1998. The Group is commonly known as the Primarolo Group (named according to the chairman of the Group Mrs. Dawn Primarolo, U.K. Financial Secretary to Treasury).
[144] The Code of Conduct contains a geographical extension to dependent or associated territories to which the Treaty does not apply (see the Code of Conduct for business taxation, paragraph M), e.g. the Netherlands Antilles, New Caledonia, Aruba, the British Virgin Islands etc.
[145] See Liebman, The EU Code of Conduct vs. The Prohibition Against "State Aid," ABA Fall Meeting, Section of International Law and Practice, October 16, 2003, Brussels / Belgium.
[146] See also Wartenburger, Die Bedeutung des Gemeinschaftsrechts für innergemeinschaftliche Steueroasen, Internationales Steuerrecht 2001, page 397 et seq.
[147] Code of Conduct for business taxation, paragraph B. However, it seems that the differentiation between tax haven jurisdictions and harmful preferential tax regimes is of a political nature. Tax haven jurisdictions are considered less co-operative and are therefore treated differently within the OECD Guidelines (see

publications it can be understood that changes are taking place in the focus of the project on harmful tax competition. The principle of transparency and the effective exchange of information play a more and more important role to achieve a "global level playing field."[148] The criterion of "no or low taxation" is used merely as a "*gateway criterion*."[149] In this regard, the Code of Conduct focuses on substantial criteria as well as transparency whereas the OECD now focuses on transparency and the effective exchange of information.

b.) The OECD Guidelines and the EU Code of Conduct deal with geographically mobile activities. However, the OECD Report is limited to financial and other service activities, whereas the Code of Conduct looks at business activities in general.[150]

c.) The OECD Report contains several specific recommendations of counteracting measures against harmful tax competition, whereas the Code of Conduct just recognises - in general - that counteracting measures play "*a fundamental role*."[151]

d.) The ongoing monitoring and the dialogue between the OECD and the jurisdictions with a preferential tax regime increases the political and economic pressure on the latter countries to abolish the harmful tax regimes (outward- and inward-looking). The Code of Conduct is - even though not legally binding for the Member States - part of a package to tackle harmful tax competition in the EU. It is therefore solely directed towards the EU Member States (inward-looking). However, the non-binding principles included in the voluntary Resolution can become binding principles through a EU Directive. In other words, the principles included in the Code can become legally enforceable at a later point in time - which will not be the case for the OECD Guidelines.

5.10.4. CFC Rules and Harmful Tax Competition

The Code of Conduct does not give any clear recommendations with respect to specific anti-avoidance provisions or countermeasures, but makes clear that those measures *"(...) contained in tax laws and in double taxation conventions play a fundamental role in counteracting tax avoidance and evasion."* [152] The OECD Report goes into more detail in this respect and gives clear recommendations for the adoption of specific anti-avoidance legislation, *inter alia,* the adoption of CFC and FIF rules.[153] Thus, it seems that anti-avoidance provisions like CFC and FIF rules are

Wartenburger, Die Bedeutung des Gemeinschaftsrechts für innergemeinschaftliche Steueroasen, Internationales Steuerrecht 2001, page 397 et seq. (401).

[148] A Process for Achieving a Global Level Playing Field, OECD Global Forum on Taxation, Berlin, 3-4 June 2004 (OECD 2004); Progress Towards a Level Playing Field: Outcomes of the OECD Global Forum on Taxation, Melbourne, 15-16 November 2005 (OECD 2005).

[149] The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries (OECD 2006), page 3, footnote 4.

[150] Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 18.

[151] Code of Conduct for business taxation, paragraph L.

[152] Code of Conduct for business taxation, paragraph L.

[153] See in more detail above.

considered by the EU and the OECD to be important measures against the national tax base erosion caused by harmful tax competition.

At first glance, the current taxation of income derived by a foreign company seems to be an effective tool to target investments in low-tax jurisdictions with a harmful preferential tax regime and tax havens. In fact, such current taxation of income makes the investment totally unattractive if the decision is only based on tax reasons and if no other - e.g. economic - reason exists. The current taxation has the effect of a taxation of income according to the domestic tax level[154] and it does not make any sense for the domestic investor to shift the financial means to another country if no other important reason exists apart from taxation. It can therefore be assumed that CFC taxation has a prophylactic effect with respect to any tax based passive foreign investment decision. However, this is only true as long as it is related to *tax avoidance* and not to *tax evasion*. The CFC rules require sufficient information on the situation in the foreign country and the activities of the taxpayer. If neither the foreign jurisdiction nor the domestic taxpayer are willing to submit the necessary information to the tax authorities, the CFC taxation cannot be applied in the appropriate manner. In other words, the application of CFC taxation requires sufficient information on the taxable income derived by the domestic taxpayer in tax-haven jurisdictions.

However, there is another aspect which is - in my opinion - of particular importance. The existing CFC rules apply, very generally, to certain types of low-taxed income derived by a foreign company and there is not always a specific reference to tax-haven jurisdictions or harmful preferential tax regimes. The CFC rules are very often equally applicable to tax regimes which are far from being harmful, just because of the fact that a lower effective tax rate applies[155] in combination with the carrying on of certain types of activity in the respective jurisdiction. Therefore, the CFC rules can rather be seen as anti-avoidance rules in order to prevent the erosion of the domestic tax base in general - applied to low-taxed passive income - but not as specific anti-avoidance provisions to stop the investment in tax havens and in jurisdictions with harmful preferential tax regimes. The CFC and FIF rules are promoted as anti-avoidance provisions against harmful tax competition, e.g. in the OECD Report, even though it is quite obvious that the existing CFC and FIF rules are in practice applied to non-harmful tax regimes as well. Of course, this "problem" was also recognised by the OECD since it stated that *"(w)hile the Recommendation only applies in the context of curbing harmful tax practices, CFC rules may also apply in situations which do not involve harmful tax practices as defined in this Report*." However, the OECD simply concluded that *"(i)t is recognised that countries retain their right to use such rules in such situations*."[156] At least from the OECD Report it is clear that CFC and FIF taxation are considered and accepted as anti-avoidance measures against harmful tax competition, even though they have a much broader scope of application. The Code of Conduct does not go into detail in this respect, and the Report of the Code of Conduct Group does not deal with that question, either, but is limited to the identification of harmful preferential tax regimes in the EU Member States and the dependent and associated territories. Clearly, there are additional questions involved in the EU context which will be discussed in more detail below.

[154] The CFC taxation can even lead to a higher level of taxation than the domestic level. This will be outlined in more detail below.
[155] Compared to the country which applies the CFC/FIF taxation.
[156] This is equally true for CFC and FIF rules. See Harmful Tax Competition - An Emerging Global Issue, (OECD 1998), paragraph 98 (CFC) and paragraph 103 (FIF).

5.11. Conclusions

1.) The current taxation of income which is derived by a non-transparent foreign legal entity in the hands of the resident shareholder is the basic feature of CFC taxation in all of the countries which apply such a regime. Such an approach is somehow "unique" and – in substance – a deviation from the principle that a foreign legal entity is to be considered a separate taxpayer.

2.) Almost all of the countries apply three basic requirements which have to be fulfilled for the application of their CFC regimes: (i) the foreign entity must derive certain passive income, (ii) there must be an ownership in the foreign entity, and (iii) the foreign income must be subject to low-taxation.

3.) The FIF rules can basically be seen as a part of (or a supplement to) the CFC rules. The main differences can be described as follows: (i) FIF rules already apply to very small and insignificant shareholdings, whereas the CFC rules require in most cases a participation of at least 10 percent or more, and (ii) FIF rules are often only applicable to certain types of passive investment income but not generally to the wide range of passive income which is in the scope of CFC taxation.

4.) The CFC rules can be seen as anti-avoidance measures in order to target the deferral of domestic taxation on foreign source income (anti-deferral measures). The CFC taxation leads to a limited application of the principle of capital export neutrality.

5.) The deferral of domestic taxation can only partially be seen as a "privilege." The income which is related to the functions exercised and the risks taken by the foreign entity should be taxable in the residence state of the CFC. At least, this is required by economic and equity aspects. However, this can be different with respect to the risk-free interest component of capital included in the passive income. To the extent that the risk-free interest component is theoretically separable from the total income, there is no necessity for a deferral of domestic taxation. Thus, the deferral which is related to the (theoretically separable) risk-free interest component of capital can be seen as a privilege rather than a necessity.

6.) The deferral of domestic taxation is, of course, of particular relevance where the income distribution is subject to tax in the state of the shareholder, e.g. where the residence state of the shareholder applies the credit method for the avoidance of double taxation. However, even if the distribution is exempt from taxation, a significant difference in tax rates can lead to the outcome that financial means are not repatriated to the parent company but retained on the level of the subsidiary company and are used for other activities, e.g. the financing of other group companies (including the parent company). Therefore, the non-distribution of financial means reduces the possibility of the parent company to create and increase taxable domestic income.

7.) Other existing anti-avoidance measures do not have an effect comparable to CFC taxation. Some of the alleged alternative measures can in fact limit the advantage of foreign passive investments in low-tax countries and can create an obstacle for abusive investments, but none of the measures really targets the deferral of domestic taxation and therefore they cannot be considered a substitute for CFC taxation.

8.) The income allocation as such is - in my opinion - in line with the ability-to-pay principle. This should even be true for minority shareholdings. The increase in value of the property which leads to passive income improves the ability of the shareholder to pay taxes. However, this is only true if the income allocation is equally relevant for positive and negative income. If the attribution is legally or factually limited to positive income, the CFC taxation cannot be in line with the ability-to-pay principle.

9.) From a technical point of view, the CFC taxation is quite similar to the taxation of permanent establishments (PE) and partnerships (PS) according to the credit method. It seems to be necessary that a country which applies a CFC taxation to foreign legal entities requires a comparable system for the taxation of PE and PS if the income is otherwise exempt from taxation. However, countries may deviate from the OECD principles of an unrestricted functional allocation of property and income, which might be particularly relevant for passive investments and intra-group activities. For example, the German concept of what is called *the central function of the head office* clearly restricts the relocation of holding, financing and licensing activities to a PE. Under the German approach it is basically impossible to allocate the property of the latter activities to a PE. If these activities are carried out by the PE, the income allocation will be limited to a (service) fee for the coordination and the handling of the activities, but will not encompass the complete amount of income related to these activities. The latter is also true if the holding, financing and licensing functions are combined with other (active) activities which are carried out by the PE. In my opinion, the deviation from the OECD approach of an unrestricted functional allocation in case of certain activities is not justified and is to be rejected.

10.) The OECD Report on Harmful Tax Competition recommends the introduction of CFC and FIF rules as counteracting measures against harmful tax competition. The EU Code of Conduct does not provide any specific recommendations, but recognises that such counteracting measures against harmful tax competition play a fundamental role. It seems that both, OECD and the Council, consider the CFC and FIF taxation to be an important tool to target harmful tax competition, even though the measures are equally applicable to low-tax regimes which are far from being harmful.

6. The Various Types and the Specific Elements of European CFC and FIF Legislation

6.1. Introduction

In the following I will describe and comment the various types and the specific elements of European CFC and FIF legislation.[1] In principle, the European CFC regimes follow a very similar pattern. However, it has to be noted that, based on the *Cadbury Schweppes* decision of the ECJ, several Member States made amendments to their CFC legislation which result in a deviation from the original pattern of CFC regimes. The aforementioned amendments are of particular importance from an EU law perspective. For this reason, these amendments will be discussed in some more detail in chapter 8 and not in this chapter.

In general, the CFC regimes have common features, such as the fact that only certain activities (and therefore certain types of income) are targeted, that it is only applied to foreign income which is taxed at a lower rate than the domestic income, and that it requires some sort of participation in the foreign company. It is therefore obvious that an overlap exists in the scope of the different CFC regimes. On the other hand, CFC taxation may be seen - in principle - as a rather "egoistic" legislation which is solely based on domestic elements and which does not sufficiently provide for a simultaneous application of CFC regimes in a multiple tier structure. In such a situation, there is an increased risk of double taxation of income which will be described later on, too.

The outcome of the following sections will be tested step-by-step with regard to the important principles derived from previous chapters. The test will not encompass EU law, because this will be tested exclusively in chapter 8.

6.2. The Transactional Approach

The transactional approach explicitly defines what is considered to be tainted (or passive) income or – as in case of Germany – defines what is generally considered to be active income with certain explicitly defined exceptions to tainted income. Irrespective of the way how it is determined in the respective legislation – as a positive or negative list of certain types of income – the important feature of this approach is the fact that only the defined income is currently taxed in the country which follows such a transactional approach. Since the tainted income is clearly marked and separated from other income it reveals more than in case of an entity approach. Therefore, the transactional approach should, in general, add important information to the understanding of CFC legislation and for the development of alternative measures. There are only a few EU Member States which follow a transactional approach, such as Spain,[2] Denmark,[3] Germany[4] and Lithuania.[5] In the

[1] As already outlined earlier, I will only use the term "CFC", which covers CFC and FIF legislation.
[2] See with respect to the Spanish CFC legislation Almudi, National Report Spain, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 559 et seq.; Jimenez, Spanien: Jüngste Gesetzesänderungen zur Hinzurechnungsbesteuerung, Unterkapitalisierungsregelung und grenzüberschreitende Lizenzzahlungen, Internationales Steuerrecht 2004, Länderbericht, page 3; Martn, Taxation of Global Operations Conducted Through a Tax Haven Subsidiary, Tax Planning International Forum, Host Country Spain, (December) 2004; Calderón, Spain, Tax Notes International 2004, page 86 et seq.; Schönfeld, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht, 2005, page 611et seq.; Calderón, Spain's Antiabuse Approach and ECJ Jurisprudence, Tax Notes International 2005, page

following, the different types of passive and base company income are discussed separately from each other.

6.2.1. The Various Types of Tainted Income

6.2.1.1. Rental Income from Immovable Property

The German provisions follow an interesting approach in dealing with rental income from real estate. Based on these rules, the income derived from the renting out of real estate is generally considered to be tainted income. However, if the taxpayer is able to show that income from the renting out of real estate would be exempt from

---

1031 et seq.; Sammarco / Pérez, Business Tax Planning Under Spain's Holding Company Regime, Tax Notes International 2005, page 47 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, pages 273, 274; Carreno, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Spain, International Transfer Pricing Journal 2007, page 338 et seq. Further references related to the Spanish CFC rules are included in the bibliography.

[3] See with respect to the Danish CFC legislation Rix, National Report Denmark, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 139 et seq.; Emmeluth, Taxation of Global Operations Conducted Through a Tax Haven Subsidiary, Tax Planning International Forum, Host Country Denmark (December) 2004; Bjornholm / Rubinstein, Denmark: Do the Lenz and Manninen Decisions Invalidate Danish Dividend and CFC Taxation, Tax Notes International 2004, page 286 et seq.; Schönfeld, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht, 2005, page 545 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, pages 275, 276; Pals / Becker-Christensen, Denmark Amends Taxation of Investment Funds, Tax Notes International 2005, page 1061 et seq.; Wittendorff, Denmark: CFC Rules Changes in the Works, Tax Notes International 2006, page 104; Smith, Recent Issues in Danish CFC Rules, Tax Planning International: European Union Focus 2006, pages 3, 4; Pedersen, New Tax Rules in Denmark – CFC Taxation and Countermeasures Against Private Equity Funds, Bulletin for International Taxation 2007, page 489 et seq.; Smith, The Revised Tax Law Proposal in Denmark, Tax Planning International: European Tax Service 2007, page 11 et seq.; Björnholm / Klemp, The Year in Review: Denmark, Tax Notes International 2007, page 1338 et seq.; Ronfeldt / Vinther / Werlauff, CFC Rules Go Up in Smoke – with Retroactive Effect, Intertax 2007, page 45 et seq.; Wittendorff, Denmark: Possible Corporate Tax Rate Cuts and Anti-Avoidance Measures, Tax Planning International Review (February) 2007; Bernsen / Byrgesen / Markholst, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Denmark, International Transfer Pricing Journal 2008, page 35 et seq. Further references related to the Danish CFC rules are included in the bibliography.

[4] See with respect to the German CFC legislation also Rust, National Report Germany, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 255 et seq.; Förster, CFC Legislation in Germany, Intertax 2004, page 476 et seq.; Killius, Taxation of Global Operations Conducted Through a Tax Haven Subsidiary, Tax Planning International Forum, Host Country Germany (December) 2004; Schönfeld, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht, 2005, page 553 et seq.; Schönfeld, Hinzurechnungsbesteuerung zwischen Steuerwettbewerb und Europäischen Grundfreiheiten, Steuer und Wirtschaft 2005, page 158 et seq.; Kramer, German CFC Legislation's Tax Haven Trapdoor, Tax Notes International 2005, page 619 et seq.; Kraft / Bron, Deutsche Hinzurechnungsbesteuerung und Europarecht - Eine Analyse vor dem Hintergrund aktueller Entwicklungen, Recht der Internationalen Wirtschaft 2006, page 209 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, pages 265, 266; Hume / Seinsche, Court Demands CFC Rules Rethink, International Tax Review 2006, page 27 et seq.; Gershuny / Israel / Borzumato / Dörr, Impact of Cadbury Schweppes on CFC Legislation, Tax Planning International Review (January) 2007; Lieber / Roeder, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Germany, International Transfer Pricing Journal 2007, page 333 et seq.; Becker / Hölscher / Loose, Impact of ECJ's Cadbury Schweppes Decision on German Tax Planning, Tax Notes International 2007, pages 879, 880; Cordewener, German 'Anti-Avoidance' Measures Versus Belgian Coordination Centres: A Long Struggle Without Survivors?, in A Vision of Taxes Within and Outside European Borders: Festschrift in Honour of Prof. Dr. Frans Vanistendael, 2008, page 203 et seq. Further references related to the German CFC rules are included in the bibliography.

[5] Lithuania joined the EU in 2005. The CFC legislation was implemented with effect as of January 2002. With respect to the Lithuanian CFC legislation see Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 391 et seq.

taxation under a double tax convention if it were derived directly by the taxpayers subject to unlimited tax liability (which hold the shares in the CFC), the rental income will be treated as active income. In most cases the German double tax conventions exempt the income derived from the renting out of real estate situated in the other contracting state.[6] For example, in case of a Swiss CFC with real estate in Italy the decisive double tax convention would not be the Swiss-Italian tax treaty but the German-Italian tax treaty. Based on that, the Italian real estate would be exempt from German taxation and therefore also the income of the Swiss CFC related to the relevant rental income.[7] The situation would be different if the real estate of the Swiss CFC was situated in Switzerland. Pursuant to the tax treaty between Germany and Switzerland the rental income is not exempt from taxation but the double taxation is to be avoided by the application of the credit method.[8] Therefore, the income of the CFC derived from the renting out of the real estate in Switzerland would be subject to the German CFC taxation. The latter clearly shows the anti-avoidance character of this provision: there should not be any possibility of sheltering the income from a Swiss real estate just because of the fact that a corporation was implemented between the German individual and the real estate. With respect to real estate located in a third country it seems to be obvious that income which is exempt in both countries, the country of the CFC and the country of the shareholder in the CFC, should not be subject to taxation in the residence state of the shareholder.[9]

Real estate which is not used for the earning of rental income but which is part of a business activity of the foreign company, in principle shares the destiny of the business activity itself. If it is categorised as an activity which produces active income this will also encompass the income which is theoretically (and indirectly) related to the immovable property.[10] In Spain, rental income derived by the foreign company is generally considered to be tainted income. However, it is explicitly outlined in Spanish law that the ownership of real estate or real property rights over such real estate is excluded from CFC taxation if the property is used for certain business activities or the use thereof has been transferred to non-resident entities belonging to the same group of companies as the owner.[11] The Danish legislation concentrates the CFC taxation on income from financial activities and the renting out of real estate is not included in the catalogue of financial activities (only leasing income which is outlined below).[12] This is comparable to the Lithuanian approach where financial leasing is considered to be tainted income.[13]

The approach of the transactional countries shows that real estate rental income can be within the scope of CFC taxation but cannot be considered a primary target. Even though the investment in real estate can be accompanied by large capital outflows, the taxing rights based on the OECD-MTC are allocable to the state in which the

[6] Based on Articles 6 and 23 (1) of the OECD-MTC.
[7] Flick / Wassermeyer / Baumhoff, Außensteuerrecht, Kommentar, § 8 AStG, paragraph 79a.
[8] Article 24 (1) No. 2 of the double tax convention between Germany and Switzerland.
[9] This is not self-evident in a situation where the income is taxable in the CFC country but tax exempt in the country of the shareholder if the double tax convention between Germany and the third country is taken into account.
[10] Of course, the theoretically allocable income is not related to rental income.
[11] Section 121 (2) letter a of the Spanish Corporate Tax Law.
[12] Frobert, Danish Official Proposes New Rules on CFC Taxation, Tax Analysts Tax Document Service, Doc. 2001-28851; Dietz / Buxbom, New Less Restrictive CFC Legislation, European Taxation 2002, page 515 et seq.
[13] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 398.

property is located.[14] Such an allocation of taxing rights avoids some of the structures which are generally considered to be inappropriate, e.g. the ownership of property in the country of the shareholder which is held by a CFC, or the interposition of a CFC in a low-tax country with property located in a third country. The source-based taxation of real estate income takes away the attractiveness, at least from a tax point of view, which - most often - adheres to the other capital intensive investments which are taxed on a residence basis. Moreover, it has to be added that real estate investments do not have the same degree of flexibility and mobility compared to other passive investments since they are - by nature - concentrated in a respective country. In those cases in which no double tax convention exists and in which the residence state of the shareholder follows the principle of world-wide taxation by (unilaterally) applying the credit method instead of the exemption method for the avoidance of double taxation, it can be argued that CFC rules are also required for rental income in order to prevent the sheltering of income from domestic taxation through the interposition of a foreign company which holds the real estate. However, if the real estate is located in a third state, the income might already be taxed at the higher rate of the latter state (and not only at the lower rate of the CFC state). If the residence state of the shareholder follows, in general, the principle of territoriality by (unilaterally) applying the exemption method for the avoidance of double taxation, there seems to be no necessity for a CFC taxation of rental income.

Thus, it should be clear, in my opinion, that foreign source rental income which is exempt from taxation - either based on a double tax convention between the residence state of the shareholder and the state in which the real estate is located or based on the general domestic concept of exempting foreign source income (in the absence of a double tax convention) - should not be subject to CFC taxation just because of the fact that a foreign company was interposed between the shareholder and the foreign real estate. In such a case, the interposition of a CFC does not lead to any tax avoidance since the income related to the foreign property will generally be outside of the scope of domestic taxation.

6.2.1.2. Leasing and Rental Income from Movable Property

The income from the leasing and renting out of movable property is in the focus of CFC taxation in all transactional countries. This is not particularly surprising since the taxing rights for such capital-intensive services - based on the OECD-MTC - are allocable to the state in which the leasing company carries on its business activities.[15] In Germany, the leasing and renting out of moveable property is considered to be tainted income, unless the domestic taxpayer can show that the foreign company maintains a business operation of leasing or renting and participates in general commerce and performs all work associated with such commercial leasing or renting without the participation of a domestic shareholder or a closely related party thereto.[16] In the same way as it is required for the provision of services in general, i.e. for base company income, it is necessary for the foreign company to fulfil the requirement of a “qualified business” in order to be exempt from

[14] See Article 6 of the OECD-MTC.
[15] Article 7 of the OECD-MTC; under the assumption that no permanent establishment exists in the other state.
[16] Section 8 (1) no. 6 letter c of the German Foreign Tax Act. With respect to the meaning of “participation in general commerce” and “without the participation of a domestic shareholder or a closely related party thereto” the subsequent explanations to base company income can be referred to.

CFC taxation.[17] Even though the wording is not completely identical, the requirements outlined below with respect to base company income can be referred to. In contrast to Germany, the Spanish CFC rules do not deal with the leasing and rental income from movable property separately. The base company provisions which deal with credit, financial, insurance and service provision activities can also be referred to.[18] In Denmark, the taxable leasing income in connection with cross-border leasing activities is considered to be financial income and therefore tainted income.[19] The same is true in Lithuania where leasing income is explicitly defined as passive income.[20]

As a result, the base company income rules and the treatment of other services under the CFC provisions can basically be referred to for the transactional countries Germany and Spain. The separation of the leasing and renting out of movable property from other services within the German catalogue of active income - even though the requirements for an exclusion from CFC taxation are quite similar to those for base company income - shows the importance of such services in the context of CFC taxation. A reason could be - in my opinion - that these are particularly capital-intensive services. However, I will go into more detail of that aspect later on.

6.2.1.3. Interest Income

Interest income is certainly the “prototype” of passive income and due to the immense flexibility of capital it is the type of income which is always in the focus of CFC taxation. In addition - and as already outlined earlier in more detail - interest income is typically taxable in the residence state of the income recipient with only a limited taxation at source. This is particularly true if the double tax convention is drafted along the lines of the OECD-MTC.[21] In the absence of CFC taxation there is a certain likelihood that capital, and therefore the basis for the production of interest income, is shifted from high-tax countries to low-tax countries for mere tax reasons and with the intention of the deferral of such income in low-tax countries.

With respect to interest income there is a different approach among the countries which follow the transactional method. In Germany, interest income is generally considered to be tainted income, and only the borrowing and lending of capital for which the taxpayer can show that it has been borrowed exclusively on foreign capital markets (and not by a closely related party) and has been granted to businesses or permanent establishments outside of Germany which derive their gross revenues exclusively or almost exclusively from active businesses, or granted to businesses or permanent establishments within Germany, is considered to produce active interest income.[22] The basic requirement that only financial means which have been borrowed exclusively on foreign capital markets can subsequently lead to active interest income excludes any financial activities which are based on equity from the

[17] 8.1.6.1. of the administrative circular. The “qualified business” in the sense of the German Foreign Tax Act will be outlined below in some detail.
[18] Section 121 (2) letter c of the Spanish Corporate Tax Law.
[19] Frobert, Danish Official Proposes New Rules on CFC Taxation, Tax Analysts Tax Document Service 2001, Doc. 2001-28851; Dietz / Buxbom, New Less Restrictive CFC Legislation, European Taxation 2002, page 515 et seq.
[20] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 398.
[21] Article 11 of the OECD-MTC.
[22] Section 8 (1) no. 7 of the German Foreign Tax Act.

benefit of deriving active income. Interestingly, in those cases where the requirements are fulfilled, the income which is considered to be active is equal to the spread between interest income and interest expenses (minus additional expenses of the finance company). This margin reflects the income which is related to the functions exercised and the additional risks taken by the finance company. The margin itself does not contain a risk-free interest component - since it is included in the interest expenses - but only the income related to the function of concentrating the borrowing of financial means and the supply of those financial means to other (group) companies and an additional risk component involved in the financing activity. The strict approach of treating any other income derived by equity based financing activities as tainted income shows that the German legislator obviously considers the transfer of those activities and the respective capital as particularly inappropriate measures with an increased risk of a domestic tax base erosion. An exclusion from CFC taxation applies to foreign banking and insurance companies if the activities are not mainly directed towards the domestic shareholder or related parties.[23]

As a general rule, the Spanish CFC legislation defines interest income as tainted income but excludes such income from current taxation where the property is held (i) in order to comply with legal or regulatory obligations derived from the exercise of business activities, (ii) in order to incorporate credit rights derived from contractual relationships established as a result of business activities, (iii) as a result of mediation activities in official capital markets, (iv) by credit and insurance entities as a result of their business activities.[24] The exclusions are very specific and it can be assumed that - with the exception of the exclusion for credit and insurance companies - it has only a limited overall impact. Apart from these exclusions, the treatment of interest income of a CFC mainly depends on the relationship between borrower and lender. In case the borrower is a related entity which is not resident in Spain, the interest income is not treated as passive income if at least 85 percent of the borrower's income result from business activities. Moreover, there is an exemption from CFC taxation if more than 50 percent of tainted income is obtained from non-associated entities. In that case, the CFC is considered to carry on business activities.[25] In addition, it is worth noting that interest income of a CFC derived from a Spanish resident person or entity will not be included in the attributable income if the interest payment is treated as a non-deductible expense in Spain. In other words, the CFC taxation will only be applicable inasmuch the payments are treated as deductible expenses.[26]

In Lithuania, interest income is considered to be tainted income and - similar to the Spanish approach - income of the CFC which is treated as non-deductible expenses in Lithuania is excluded from CFC taxation. This rule was enacted in order to avoid the double taxation of income.[27] In Denmark, the focus is clearly on financial income

[23] Section 8 (1) no. 3 of the German Foreign Tax Act.
[24] Section 121 (2) letter b of the Spanish Corporate Tax Law; Garcia Prats, National Report Spain, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 812.
[25] Garcia Prats, National Report Spain, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 813.
[26] Section 121 (2) letter c of the Spanish Corporate Tax Law.
[27] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 398.

and interest income is therefore considered to be tainted income.[28] However, an exemption was introduced for foreign subsidiaries which conduct license, insurance or banking businesses that are subject to public supervision, provided that the subsidiary conducts business mainly with customers in its own country of residence, and mainly with third parties.[29]

The transactional countries do not follow a uniform approach with respect to the qualification and the treatment of interest income in the context of CFC legislation. However, there is to a great extent an overlap of the different approaches and similarities can be identified. Especially with regard to interest income from inter-company financing activities and portfolio activities it can be concluded that

- the interest income related to the financing of the domestic shareholder (parent company) leads to income which is subject to CFC taxation.[30] In a typical case, the CFC is financed by equity which will then be routed to the domestic parent company by way of loan amounts. Such a structure has a direct impact on the domestic tax base. All of the aforementioned transactional countries consider the income derived by the CFC under these circumstances to be passive income which is subject to current taxation.[31]

- the interest income related to the financing of other group companies resident elsewhere is generally also subject to CFC taxation in the transactional countries. However, Spain does not follow this approach if the borrower derives at least 85 percent of his income from business activities, i.e. activities which do not lead to passive income. Based on this approach, the Spanish rules differentiate between loan amounts granted by the CFC to foreign active companies and those granted to domestic active companies.

- portfolio interest income is generally considered to be passive income. Under certain circumstances, the activities of credit, banking and insurance businesses are excluded from CFC taxation. The requirements to exclude those activities from CFC taxation are different, but it seems that the general requirement is that the activities have to be mainly directed towards third parties.

6.2.1.4. Royalty Income

Similar to interest income, the taxing rights related to the income from intangible assets are – pursuant to Article 12 of the OECD-MTC – allocable to the residence state of the beneficial owner of the intangible assets.[32] The residence-based taxation of royalty income in combination with the – in most cases – uncomplicated transferability of intangible assets increases the likelihood that such property is transferred to low-tax countries. The attractive feature from a tax point of view is that with the transfer of the intangible property the taxing rights are "automatically"

[28] See Rix, National Report Denmark, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 145.
[29] PricewaterhouseCoopers LLP, Danish Parliament Approves Corporate Tax Incentives, Tax Analysts Tax Document Service 2002, Doc. 2002-12665.
[30] In Spain this is dependent upon the deductibility of the interest expenses. If the interest expenses are non-deductible, the foreign income will not be subject to current taxation in Spain.
[31] See in this respect also the base company rules outlined below.
[32] Article 12 (1) of the OECD-MTC.

transferred to the other country, too. It is therefore obvious that royalty income is regularly subject to CFC taxation. Within the transactional countries Germany follows a very strict approach according to which the granting of authorised use of rights, plans, designs, processes, know how and skills leads to passive income unless the taxpayer can show that the foreign company commercialises the results of its own research and development work undertaken without the participation of a taxpayer holding shares in the company or a closely related party to such a taxpayer.[33] This is a far-reaching provision since it comprises all income related to intangible assets purchased from related or unrelated parties, i.e. even if the CFC *purchases* the property from a third party and makes the property available to another third party without any involvement of the domestic shareholder and any related party, the income will be subject to CFC taxation.[34] Furthermore, the provision also comprises the intangible property which is the result of one's own research and development work under certain circumstances, namely where a related party was involved in the research and development activities.[35] In other words, only royalty income from the making available of intangible assets which are *developed* by the CFC itself without the involvement of the domestic shareholder or a related party is considered to be active income. Thus, it is of importance for the application of the German CFC rules whether (i) the intangible property which is exploited was *self-developed* or *non-self-developed* (purchased) by the foreign company and - in the first-mentioned situation - whether (ii) the domestic shareholder was involved in the development of the intangible property. Denmark, which is focused on financial income, has a similar approach according to which royalties and gains on the sale of intangible assets are considered to be tainted income, provided that the CFC itself did not develop the intangible assets.[36] An exemption exists for license companies which are subject to public supervision, provided that the subsidiary conducts business mainly with customers in its own country of residence, and mainly with third parties.[37] The Spanish rules are not comparably strict and do not encompass royalties derived from related persons or companies which are not resident in Spain (see the explanations with respect to interest income).[38] Thus, if the royalties do not reduce the tax base in Spain because the recipient of the services is not resident in Spain the royalty income will not be subject to Spanish CFC taxation. It seems that the Lithuanian rules are not explicitly focused on royalty income as passive income - but the base company rules have to be referred to.[39] In general, the inter-company transactions of a CFC with resident companies will be covered below where base company income is outlined.

In the same way as described above with respect to interest income, the CFC rules of the transactional countries are not identical but they have a similar approach. It

[33] Section 8 (1) no. 6 letter a of the German Foreign Tax Act (Außensteuergesetz - AStG).

[34] Flick / Wassermeyer / Baumhoff, Außensteuerrecht, Kommentar, § 8 AStG, Rz. 224; Mössner in Brenzing et al. , Außensteuerrecht, Kommentar, § 8 AStG, Rz. 69.

[35] The participation of a related party will be discussed in more detail later on in the context of base company income.

[36] Frobert, Danish Official Proposes New Rules on CFC Taxation, Tax Analysts Tax Document Service, Doc. 2001-28851

[37] PricewaterhouseCoopers LLP, Danish Parliament Approves Corporate Tax Incentives, Tax Analysts Tax Document Service 2002, Doc. 2002-12665.

[38] Almudi, National Report Spain, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 565.

[39] Apart from the remuneration for author's work (see Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 398).

seems that the active-passive classification requires additional features – compared to the active-passive classification of interest income – and can therefore not be implemented in the more general base company rules. It can be concluded that

- most of the transactional countries consider royalty income derived by the CFC from the domestic shareholder (parent company) to be tainted income which is subject to CFC taxation. This is comparable to the treatment of interest income derived by the CFC which is outlined above.[40]

- royalty income derived by the CFC from other group companies resident elsewhere is generally also subject to CFC taxation in Germany and Denmark, but not in Spain. The same is basically true for royalty income derived from unrelated parties. In Spain, the royalty income of the foreign company will not be subject to CFC taxation if the royalty payments are related to non-residents and are not deducted as business expenses in Spain. Thus, it might be concluded that in the latter case there is an additional separation, in contrast to other transactional countries, between a “direct” and an “indirect” tax base erosion. If the *services* of the CFC (and therefore also the exploitation of intangible property) result in an immediate reduction of the domestic tax base, this might be seen, in my opinion, as a direct tax base erosion. If this is not the case - because the recipient is a non-resident recipient - this might be seen as an indirect tax base erosion (because it is merely a relocation of services to the CFC but no (additional) immediate direct reduction of the domestic tax base).

- an exemption from CFC taxation exists where the intangible assets are developed by the CFC itself (Germany and Denmark) and without the participation of the domestic shareholder (Germany). In Denmark, an additional exemption exists for license income if the subsidiary is subject to public supervision and if the license income is mainly derived in the residence state of the CFC and mainly from third parties. The Spanish legislation does not differentiate between self-developed and non-self-developed, but provides for the above mentioned exemption in case of non-resident recipients.

6.2.1.5. Dividend Income

It was outlined earlier in this study that dividend income should - from my point of view - be exempt from taxation in the country of the parent company. Of course, this should be equally true for any indirect taxation of dividends through the application of CFC rules. The German CFC rules follow such an approach and exclude any dividends from the CFC taxation, irrespective of the percentage of shareholding and irrespective of the nature of income which is “behind” the dividend payment, i.e. whether the income is earned through an activity which is passive or active.[41] This results in a full exemption of dividend income from CFC taxation.[42] As a rule, the Spanish CFC legislation considers the income derived from interests in the equity of a foreign company to be tainted income and, in general, the same exclusions apply

[40] However, countries like Lithuania which do not explicitly mention the royalty income as passive income in such a situation have base company rules which typically cover such CFC income (see below).
[41] Section 8 (1) no. 8 of the German Foreign Tax Act.
[42] However, an amount of 5 percent is added to the domestic tax base as non-deductible expenses (§ 8 b (5) of the German Corporate Income Tax Act).

as described above with respect to interest income.[43] However, the Spanish law provides for an additional important exception to the general rule where the CFC acts as a holding company. This requires that (i) the CFC holds an interest of more than 5 percent in the foreign company, (ii) the CFC supervises and manages the interests, through the corresponding organisation of human and material resources, and (iii) at least 85 percent of the income of the entities from which the income is obtained result from business activities.[44] Even though this exempts dividend income from substantial participation in active companies with more than 5 percent, the portfolio investment in shares remains tainted income and therefore subject to the Spanish CFC taxation. In Denmark, dividends are considered to be income from financial activities and therefore tainted income. In general, this is irrespective of the percentage of shareholding, i.e. not only portfolio dividends but also dividends received from substantial shareholdings are affected.[45] The Lithuanian CFC legislation considers dividend income to be passive income, too.[46] As a result, only the German approach excludes all dividend income from current taxation – even portfolio dividends – whereas the other transactional countries still focus on portfolio dividends.

6.2.1.6. Capital Gains on the Sale of Shares

The tax treatment with respect to controlled foreign companies in the transactional countries Denmark, Spain and Lithuania generally follows the treatment of dividends.[47] This is a consistent approach since the capital gains on the disposal of shares theoretically reflect the retained profits and the prospective future development of the entity. In Germany, the tax treatment of capital gains realised by the CFC on the disposal of shares deviates from the tax treatment of dividends received by the CFC. As already outlined above, dividends received by the CFC are explicitly excluded from the German CFC taxation.[48] In contrast thereto, capital gains are only excluded if the taxpayer can demonstrate that the capital gain is not connected to (tainted) income which is related to assets of a capital investment kind.[49] The legislator wanted to avoid situations in which tainted income - which has not yet been realised and is therefore not subject to CFC taxation - is transferred to another person simply by transferring the shares in the company. The provision is therefore directed to avoid the circumvention of the German CFC legislation. Of course, dividends and capital gains on the sale of shares are, in principle, two sides of the same coin. It seems to be logical, therefore, to treat both transactions in an identical manner, i.e. to exclude both from the classification as tainted income. This would be a consistent approach. However, one has to admit that capital gains on the

[43] Section 121 (2) letter b of the Spanish Corporate Tax Law.
[44] Section 121 (2) of the Spanish Corporate Tax Law; Garcia Prats, National Report Spain, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 812.
[45] Sorensen, National Report Denmark, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 466, 467.
[46] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 398.
[47] Frobert, Danish Official Proposes New Rules on CFC Taxation, Tax Analysts Tax Document Service, Doc. 2001-28851; Dietz / Buxbom, New Less Restrictive CFC Legislation, European Taxation 2002, page 515 et seq.; section 121 (2) letter d of the Spanish Corporate Tax Law; Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 398.
[48] Section 8 (1) no. 8 of the German Foreign Tax Act.
[49] Section 8 (1) no. 9 and section 7 (6a) of the German Foreign Tax Act.

sale of shares (made by the CFC) can encompass, in contrast to dividend income, a part of unrealised profit which is related to tainted activities which have not yet been subject to CFC taxation. It might be possible, therefore, to *transfer* income which would normally be subject to CFC taxation into (exempt) capital gains. This is not the case for dividends because dividends are based on income which has already been realised and which was either subject to CFC taxation or not subject to CFC taxation. However, instead of implementing a different treatment - at least partially - of dividends and capital gains it might be better, in my opinion, to adjust the income determination rules for the stipulation of the tainted income. Moreover, the partial non-exemption of capital gains could lead to a double taxation of income: the non-realised tainted income might be taxed (indirectly) through the capital gains taxation and subsequently when it is realised (indirectly) according to the CFC regime of the state of the purchaser (and, of course, the CFC state). It can also lead to problems regarding the provision of an appropriate crediting of the taxes imposed in the CFC state on the subsequently realised income. I will come back to those aspects later on in more detail.

6.2.1.7. Other Capital Gains

It is obvious that a CFC taxation of certain income components requires also a capital gains taxation related to the underlying assets in order to avoid the circumvention of CFC taxation and to ensure the complete taxation of such tainted income. In Denmark, the financial income which is subject to CFC taxation also encompasses the taxable gains on claims, debts, and financial contracts, as well as the gains on the sale of intangible assets.[50] Comparable rules exist in Spain[51] and Lithuania.[52] It is worth noting in this context that the transactional countries calculate the taxable CFC income according to domestic tax rules. This basically ensures that all taxable gains which are taxable pursuant to domestic law are also included in the current taxation if such gains occur within the CFC. However, this does not prevent a shifting of tainted income which is included - unrealised - in certain assets of the CFC where (i) the shares are sold to another (foreign) taxpayer and (ii) no capital gains taxation exists on the sale of shares. Therefore, it is obvious that - for example - the German CFC rules require a specific provision to deal with such a situation and to tax the disposal of shares under certain circumstances (see above).

6.2.1.8. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The separation of income (and activities) under the transactional approach of the countries outlined above only partially fulfils the requirements which were identified in chapters 2 and 3. One of the important aspects is certainly the fact that the transactional approach provides for a mere horizontal separation of income by focusing on “tainted” income which is to a large extent related to capital intensive activities. The latter activities usually contain a separable financing element (e.g. included in interest, leasing, rental and royalty income). This, of course, is clearly

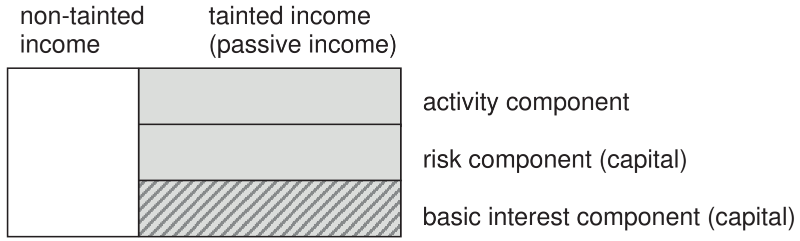
[50] Frobert, Danish Official Proposes New Rules on CFC Taxation, Tax Analysts Tax Document Service 2001, Doc. 2001-28851; Dietz / Buxbom, New Less Restrictive CFC Legislation, European Taxation 2002, page 515 et seq.
[51] Section 121 (2) letter d of the Spanish Corporate Tax Law.
[52] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 398.

what has to be identified under an efficient and target-oriented anti-avoidance (anti-deferral) legislation which is based on the current taxation of income and which is concentrated on the hybrid structures outlined earlier. However, it is equally clear that the focusing on a mere horizontal separation of income is by far not sufficient. The problem is that the transactional approach leads to a taxation of the total amount of tainted income which does not only encompass the basic interest component but also any other components - including those which are clearly connected to an "active" activity (within the tainted activity) carried out by the CFC. In other words, any economic output which is produced by the CFC in the context of receiving interest income, leasing income, rental income and royalty income is subject to current taxation in the state of the shareholder. This, without any doubt, is neither acceptable from an economic perspective nor from an equity perspective - which theoretically require the taxation of income to follow, in general, the principle of capital import neutrality and the current taxation to be strictly limited - in a non-optimal scenario - to the basic interest component. Thus, the income which is produced by the CFC in its state of residence should be taxed exclusively in the latter state and not, in addition, on a current basis in the state of the shareholder. It does not matter whether the income produced by the CFC is linked to an "active" or "passive" activity.

Similar aspects are relevant for the income which is related to the risk component. Although the risk component is not produced by the CFC it was concluded that the latter component, which is part of the tainted income, should be taxed exclusively - in a non-optimal scenario - in the CFC state. This ensures a consistent treatment of positive and negative income related to the risk component. It is apparent that there is a correlation between the positive income included in the risk premium and the negative income which is realised in case an event arises which is theoretically covered by the risk component, i.e. if the risk becomes reality.

Essentially, the fact that the transactional countries outlined above tax the activity component and the risk component (included in the tainted income) on a current basis is due to the complete lack of a vertical separation of income in all of these countries. The following figure illustrates the decisive difference with respect to the existing transactional regimes which merely focus on a horizontal separation of income and the concept based on chapters 2 and 3 which requires a strict horizontal and vertical separation of income.

Figure 1:



Explanations:

(1) "Income block" divided into non-tainted and tainted income (horizontal) and into the three different income components which are of importance for capital intensive activities (vertical). The vertical separation of the non-tainted income is not required, because no element is included which should be subject to the current taxation of income in the state of the shareholder.
(2) Assumption: passive activities under the CFC regimes = tainted activities under the concept of basic interest taxation.
(3) White area: not subject to income allocation.
(4) Grey area: subject to income allocation under a transactional approach CFC taxation.
(5) Grey-striped area: subject to income allocation under transactional approach CFC taxation and under the concept of basic interest taxation.
(6) The size of the three income components is just an assumption.

In the illustration above it was assumed, for the purpose of simplification, that the tainted activities under a transactional approach CFC taxation are identical to those required under the concept of basic interest taxation. It is apparent that financing activities, licensing activities as well as leasing and rental activities which are related to movable property are usually within the focus of transactional CFC regimes. The latter types of activities contain a separable financing element, as already mentioned above, and - in combination with the residence-based taxation of the respective income in the CFC state - are therefore particularly attractive in the context of hybrid structures. For this reason, the aforementioned activities should also be considered in an alternative concept which is based on the taxation of the basic interest component. However, it should not be overlooked that the transactional countries do not have a uniform approach with respect to the horizontal separation of tainted and non-tainted income and that the qualification is by far not restricted to the question whether the income is subject to a residence-based taxation in the CFC state or not. In my opinion, and based on the conclusion of the previous chapters, the decisive question must be whether the basic interest component is "taxed at the right place" - namely the state where the income is produced. If the income is not taxed in the state where it is produced, but in the residence state of the CFC, there seems to be a necessity for a current taxation of the basic interest component. In principle, the conclusion that the income from capital intensive activities which includes a financing element has to be separated not only horizontally but also vertically is equally relevant for interest income, royalty income, leasing and rental income (related to movable property) and similar types of income. There might be reasons for a (further) exemption from current taxation, especially from a simplification and administrative perspective, but this shall be outlined and discussed in chapter 9. However, what is relevant here is the fact that there is no simple and straight-forward horizontal separation of income - and no vertical separation of income at all - under the existing transactional approach CFC rules.

With regard to leasing and rental activities related to immovable property the situation is a bit different from the activities mentioned above. Here, the right to tax the respective income is usually allocated - according to Article 6 (1) of the OECD-MTC - to the state of source (i.e. the source-based taxation is the general rule and not the exception). In this case, there is no necessity for any current allocation of the basic interest income to the resident shareholder. However, in those cases in which the taxing rights are allocated to the CFC state there is, in principle, no reason to treat the leasing and rental activities related to immovable property differently from the other types of capital intensive activities which contain a separable financing element and which are subject to residence-based taxation in the CFC state. From the examination of the transactional countries it seems that these countries often do not follow, as already mentioned above for other types of income, a simple and straightforward horizontal separation between tainted and non-tainted income which is dependent upon the question whether the CFC state has the right to tax the income or not. See in this respect, for example, the complex German rules regarding the taxation of income from immovable property which substantially deviates from the proposed general principles.

I have already pointed out that the income from dividends received by the CFC and the income from capital gains realised from the disposal of shares by the CFC should not be subject to current taxation, neither under the existing CFC regimes nor (with respect to the basic interest component) under an alternative legislation. This should be equally true for substantial shareholdings and portfolio shareholdings. In other words, income from dividends and capital gains on the disposal of shares should be completely excluded from an anti-avoidance (anti-deferral) legislation which is based on a concept of a current taxation of income. Apparently, there is not one single country among the transactional countries which strictly follows a consistent treatment of income from dividends and capital gains from the disposal of shares. In contrast thereto, it is understandable and consistent that the existing CFC regimes provide for the taxation of capital gains which are related to the disposal of other property which is utilised for the generation of tainted income. Any other approach would provide the possibility to circumvent the CFC taxation. However, the concept of basic interest taxation - with the combination of a horizontal and a vertical separation of income - has to follow a different route. This will be outlined in more detail in chapter 9 where an alternative concept will be presented.

6.2.1.9. Preliminary Conclusions

Different conclusions can be drawn with respect to the tainted (or passive) income outlined above, especially with respect to income from the leasing and renting out of movable property, interest income, royalty income, dividend income, and income from capital gains.

a.) The element of mobility

The income described above as tainted or passive income is often considered to be a "mobile form of income."[53] In my opinion, it is rather the underlying capital investment (for example the tangible or intangible property) which is extremely mobile and, thus, also the part of the income which is related thereto. For example, a major factor in case of leasing activities is the investment in the respective property. However, since the property will be purchased by the lessor but transferred and used by the lessee, the part of the activity which is related to the investment - in the narrower sense - can be seen as highly mobile. Nevertheless, any activities connected with the investment are as mobile or immobile as other comparable services which require personnel to prepare the investment, to do the bookkeeping, the calculations, the marketing (if it is not only related to group companies) and so on. It can be concluded that all passive activities outlined above have in common that it is not the income as a whole which is

[53] OECD, Controlled Foreign Company Legislation, Studies in Taxation of Foreign Source Income, 1996, page 49.

extremely mobile, but that the major part of the income is derived by an element which is extremely mobile. If such an element prevails within a certain activity, it makes the whole activity relatively mobile. It is certainly clear that the income from the leasing and renting out of movable property, interest income, royalty income, dividend income (and related hereto the income from capital gains) is very much influenced by a significant part of income which is related to extremely mobile capital investment.

b.) The "capital factor"

The element of mobility outlined above is strongly related to the extent of capital investment included in the overall activity and the significance of all other elements compared to the mere capital investment. It is clear that highly complex production or development activities most often contain considerable capital elements, too, but in contrast to the passive activities described above the intellectual element is much more important and not comparably replaceable. With respect to the aforementioned income it can be clearly stipulated that the factor of capital is a major element of the activities. Furthermore, it is quite obvious that - at least with respect to mere inter-company activities - the accompanying elements are of less significance compared to the capital investment. An important part of the income derived from the passive activities is the interest component of capital. The best example is certainly the interest income from inter-company loans where the whole income is related to the capital provided. In case of intra-group cash pooling activities the income also includes a small element to cover the accompanying services. In case of the leasing and renting out of movable and immovable property a significant part of the income refers to an interest component of the capital invested and the amortisation of the property. The same is basically true for royalty income from intangible property. The investment in shares in order to earn dividend income or a subsequent capital gain from the disposal of the shares is - in general - slightly different with respect to the interest component. However, it is quite clear that the income can be derived from the capital investment without any other accompanying activity exercised by the shareholder.

The performance of those activities makes it possible to earn a significant part of the income by employing capital and, at the same time, typically does not require a great number of highly skilled employees and extensive facilities. In my opinion, the mobility increases with the degree of income related to the capital investment. In other words, the higher the income related to the capital investment, the greater the overall mobility of the activity.

c.) The residence-based taxation of income

What is now important from a tax point of view is the fact that any transfer of these mobile activities, which are mainly based on capital investments, leads to a shifting of taxing rights. That means, if a parent company decides to incorporate a foreign subsidiary in a low-tax country which is responsible for certain intra-group service activities, this will generally lead to a shifting of taxing rights from the parent company to the foreign subsidiary in the low-tax country. Leaving aside a limited taxation in the source state by way of a withholding tax, this is generally true - based on the OECD-MTC - for nearly all of the passive activities outlined above, namely the income from the leasing and renting out of movable property,[54] interest income,[55] royalty income,[56] dividend income,[57] and capital gains related thereto.[58] However, this is not true with respect to rental income from immovable property and the respective capital gains taxation.[59] In substance, there is a great flexibility with respect to the place of taxation of income related to capital investments in the situations outlined above (with the exception of income from immovable property).

d.) Direct tax base erosion

It is important to recognise that the relocation of the activities described above and the corresponding transfer of taxing rights to a low-tax country does not in all cases lead to the application of the respective CFC taxation. However, all transactional countries focus on situations where (i) activities are relocated to a foreign low-tax country and (ii) the activities are directed towards the domestic shareholder (parent company), i.e. the activities lead to deductible business expenses in the residence state of the shareholder and therefore to a direct reduction of the domestic tax base.

e.) Indirect tax base erosion

An indirect tax base erosion can exist in situations where activities are relocated to a foreign subsidiary in a low-tax country and the services provided by the foreign subsidiary are not directed towards the domestic shareholder but instead towards other group companies. In contrast to the direct tax base erosion, the services will not have an immediate impact on the domestic tax base in the form of deductible expenses, but lead to an erosion of the domestic tax base through the fact that the services in question are not provided from within the residence country but from within the foreign country, and therefore do not produce taxable income in the country of the shareholder. The CFC rules of the transactional countries Germany and Denmark both focus on the direct and indirect tax base erosion, i.e. income from the leasing and renting out of movable property, interest income, and royalty income is considered to be tainted income irrespective of the fact whether it is provided towards the domestic shareholder or any other non-resident related party. The Spanish rules are not comparably strict and do not encompass income derived by the CFC from services provided to non-resident recipients - under certain circumstances - which do not lead to deductible expenses in Spain.

6.2.2. Base Company Income

6.2.2.1. General Aspects

Another form of tainted income - although different from the aforementioned types of passive income - is the so-called “base company income.” The base company income comprises the supply of services - and in some cases even the supply of goods - under certain circumstances, especially where the domestic shareholder or other group companies are somehow involved in the transactions. Theoretically, and

[54] Article 7 of the OECD-MTC.
[55] Article 11 of the OECD-MTC.
[56] Article 12 of the OECD-MTC.
[57] Article 10 of the OECD-MTC.
[58] Article 13 of the OECD-MTC.
[59] Article 6 (1) and Article 13 (1) of the OECD-MTC.

in contrast to the passive income outlined above, this can affect all kinds of trading and service activities.

6.2.2.2. Income Subject to CFC Taxation under the Base Company Rules

According to the general concept of the German base company rules, income derived from trading activities is considered to be active income, unless a domestic taxpayer[60] holding shares in the foreign company has supplied the goods to the foreign company, or the goods have been supplied by the foreign company to such a domestic taxpayer. Service income is also considered active income, unless the foreign company makes use for the services of a domestic taxpayer holding shares in the foreign company or a closely related party to such a domestic taxpayer and who is liable to tax for its income from services rendered within Germany; or the foreign company performs the services to such a taxpayer. In principle, this is not true, i.e. the income is not considered to be tainted income, if the taxpayer can show that the foreign company maintains commercially equipped offices[61] for such trading or service activities and takes part in general commerce[62], and if the foreign company conducts work on preparing, concluding and implementing such business without the participation of such a domestic taxpayer ("qualified business").[63] However, it is

[60] Alternatively, a closely related party to such a domestic taxpayer. This is also true for the following references to the domestic taxpayer in the context of the German base company rules.

[61] The requirement of maintaining commercially equipped offices is fulfilled if the foreign company is from a practical and personnel point of view in a position to prepare, conclude and implement the respective supply of goods and services by itself and independent from the shareholder and related parties (paragraph 8.1.4.2.1. (trading) and paragraph 8.1.5.1.2. (services) of the administrative circular).

[62] The participation in general commerce requires that the activity of the foreign company is not only limited to related parties but is instead - not only to a minor extent - directed towards an indefinite number of persons. An indirect participation in general commerce only through related parties is not sufficient. However, it is not harmful for the qualification if the number of customers is limited simply by the fact that the goods provided are, by nature, only limited to a small number of customers (see paragraph 8.1.4.2.3. (trading) and paragraph 8.1.5.1.2. (services) of the administrative circular; see also German Supreme Tax Court, dated August 29, 1984, I R 68/81, BStBl. 1985 II page 120 et seq.). Based on the administrative circular of the German Ministry of Finance, it should be sufficient only for the outward activities, e.g. the sales and services, to be directed towards an indefinite number of persons but for the respective inward activities, e.g. the purchase of goods, to be limited to only one related party. The same is true for the opposite situation, i.e. the providing of sales and services to only one related party but with the purchase of goods or the receipt of services from an indefinite number of third party suppliers (see paragraph 8.1.4.2.2. (trading) and 8.1.5.1.2. (services) of the administrative circular). However, it is quite unclear where the borderline has to be drawn. A foreign sales company which purchases all goods from the domestic parent company (production company) but supplies those goods to several customers in the local market will certainly participate in general commerce. But what about a foreign company which operates a call centre only for group companies? The foreign company will most certainly receive third party services - but only to a limited extent. In contrast to the administrative circular, the German Supreme Tax Court made it very clear - in a case dealing with inter-company services - that the requirement of participating in general commerce is not fulfilled if the services are only provided within a group of companies and the limitation is due to the respective intra-group structure. Since the criterion of a participation in general commerce is not only relevant with respect to the German Foreign Tax Act but also for income tax and trade income tax purposes, the Court referred to existing case law. Thereto, the criterion requires that the provision of services is not restricted to certain persons. Even though the business activities can be restricted to certain types of customers the activity as such must be open for changes in the person who receives the services. Any general limitation on certain customers does therefore not fulfil the requirement of a participation in general commerce (see in this respect German Supreme Tax Court, dated August 29, 1984, I R 68/81, BStBl. 1985 II page 120 et seq. and German Supreme Tax Court, dated May 12, 1960, IV 159/59 U.BFHE 71, 221, BStBl. 1960 III page 331).

[63] In case of trading activities, the domestic shareholder (or a closely related party thereto) is involved in the performance of the activity of the foreign company if functions are exercised by the shareholder (or the related party) which are related to the preparation, conclusion and implementation of the businesses (see section 8 (1) no. 4 of the German Foreign Tax Act; 8.1.4.3.1. of the administrative circular). This is irrespective of the

important to note that the provision of services by the CFC will always lead to tainted income if the CFC makes use of the domestic taxpayer for the services. In this case, the question of a "qualified business" does not matter, i.e. if the domestic taxpayer is involved in the supply of services, it will be tainted income - without exception.[64] Overall, the German rules strictly focus on the circumstances of the supply of goods / services and not on the type of income. In other words, the relationship - and the interrelation - between the supplier of goods / services and the recipient is the decisive element for the qualification of tainted income under the base company rules and the question whether the income is subject to current taxation or not.

The Spanish base company rules follow a different pattern. Spanish tax law states that credit, financial, insurance and service provision activities, except for those directly related to export activities, which are performed directly or indirectly with related persons or entities[65] resident in Spanish territory lead to tainted income inasmuch as the activities determine tax deductible expenses for the persons or entities resident in Spain.[66] The income will not be included in the Spanish tax base if it corresponds to expenses which are not tax deductible for Spanish resident entities.[67] Moreover, the income will not be included in the Spanish tax base in case more than 50 percent of the income derived from credit, financial, insurance or service provision activities, except for those directly related to export activities, carried on by the foreign company arises from operations performed with unrelated parties.[68] The Spanish base company rules are therefore strongly related to the question whether the income of the foreign company leads at the same time to deductible expenses in Spain, i.e. whether the domestic tax base is *directly* reduced. An *indirect* reduction of the domestic tax base caused by the provision of certain services (which are not separately qualified as passive income, e.g. interest income, rental income) between a non-resident group service company and another non-resident group companies is not covered by the base company rules. This is an obvious difference to the German concept: under the German base company rules there is no requirement of a (direct) reduction of the tax base caused by the supply of goods / services. Instead, the involvement of the German shareholder in services provided by the CFC to another party may trigger the application of the CFC rules even without any direct impact on the domestic tax base. In addition, the German rules do not - in contrast to the Spanish rules - provide for a link to the tax deductibility of the payments for the services, either.

Pursuant to the Lithuanian CFC rules, income of a CFC which is not explicitly marked as passive income (e.g. interest income, leasing income) is subject to CFC taxation under the following circumstances:

question whether the function is exercised free of charge or against an arm's length consideration. A minor involvement does not lead to passive income if the activity as such is an active business. The wording with respect to services is slightly different since it only states that the services have to be performed without the participation of the domestic shareholder (or a closely related party thereto). However, it must be concluded for trading and service activities that the involvement of the domestic shareholder leads to tainted income (if it is not only a minor involvement).

[64] Section 8 (1) no. 5 letter a of the German Foreign Tax Act.
[65] In accordance with the definition of section 16 of the Spanish Corporate Tax Law.
[66] Section 121 (2) letter d of the Spanish Corporate Tax Law.
[67] Section 121 (4) of the Spanish Corporate Tax Law.
[68] Section 121 (2) letter d of the Spanish Corporate Tax Law.

- the foreign entity does not have a sufficient number of employees that is usually required to ensure the activities in the country where the CFC is incorporated or otherwise organised; or

- more than 10 percent of income during a fiscal year is derived from sources outside the country of incorporation (or organisation) of the CFC; or

- 50 percent (or more) of the income of the CFC during a fiscal year is derived from business transactions with related parties.[69]

If one of the three conditions is fulfilled, the respective income will be subject to CFC taxation in the hands of the resident shareholder. The Lithuanian CFC regime also provides for an exception to the attribution of CFC income in those cases in which the (corresponding) expenses paid by the domestic taxpayer to the CFC are treated as non-deductible expenses. This rule was enacted to avoid a possible double taxation of income.[70]

The Lithuanian concept shows again the typical features of base company rules: activities which are usually seen as "active" are subject to CFC taxation just because of the circumstances of the transactions. Here, it is either the "insufficient" number of personnel, the percentage of income derived outside the state of residence of the CFC, or the percentage of income derived from business transactions with related parties. With respect to the latter element, the Lithuanian and Spanish base company rules follow a very similar concept: both regimes require a substantial amount of third party transactions in order to be excluded from CFC taxation (more than 50 percent) or, the other way round, both regimes target income which is derived from activities with related parties if a certain threshold is exceeded. In contrast thereto, the German base company rules do not set a comparably strict threshold. Moreover, there is an additional similarity between the Lithuanian and Spanish base company rules: both regimes do not attribute the income elements which were treated as non-deductible expenses in Lithuania and Spain, respectively. On the other hand, the Lithuanian rules are very strict, in contrast to Spain and Germany, when it comes to the question of deriving income outside of the state of residence of the CFC. A general threshold of 10 percent for income from sources outside the CFC state seems to be rather low and apparently an unusual threshold. Clearly, all of the aforementioned states focus on transactions with residents of the state which applies the CFC rules (especially Spain with the direct link to the tax base of Spanish residents). However, there is no comparably strict approach in Spain and Germany when it comes to third countries.

In Denmark, the focus is clearly on financial income. There are no provisions which trigger the application of the Danish CFC rules - just because of the circumstances of the transactions - if the income is not classified, at the same time, as financial income. In this respect, the Danish rules differ from the rules applied in the other transactional countries outlined above. Nevertheless, in order to have a complete picture of the transactional approach countries and to identify the differences in the CFC concepts it is helpful, in my opinion, to include the Danish legislation in this part

[69] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 398, 399.
[70] Article 31 of the Lithuanian Law on Profit Tax; Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 398.

of the chapter as well. According to the Danish CFC legislation the income of the foreign company is considered to be tainted income if it is of a financial nature and if a certain threshold is exceeded - which is one-third of the total net income of the CFC calculated under Danish rules. The following types of income are considered to be tainted income:[71]

- interest income;
- taxable gains on claims, debts, and financial contracts;
- commissions;
- taxable dividends and gains on the sale of shares;
- royalties and gains on the sale of intangible assets, provided that the subsidiary did not develop the intangible assets;
- deductions in connection with the aforementioned items;
- taxable leasing income in connection with cross-border leasing activities;
- income in connection with insurance, bank, or mortgage activities.

However, an exemption exists for foreign companies which conduct license, insurance or banking businesses that are subject to public supervision, provided that the foreign companies conduct business mainly with customers in their own countries of residence, and mainly with third parties.[72] In my opinion, the Danish rules cannot be seen, in a stricter sense, as base company rules. The reason is that the Danish CFC regime focuses on pre-defined financial income and does not include a provision which re-qualifies non-tainted income as tainted income just because of the circumstances of the transactions, e.g. if the CFC provides non-financial services solely towards related parties outside of the CFC state. In other words, it is, in principle, clear in Denmark which types of income are in the focus of the CFC regime and which are outside of the latter regime. However, such a pre-determination of income has the consequence that the regime is, at least to a large extent, focused on capital intensive activities. This, of course, comes closer to a concept which is concentrated on the current taxation of the basic interest component (although a vertical separation of income is not provided under the Danish CFC regime, either) than a regime - like in Germany, Spain and Lithuania - which may result in the CFC taxation of income which is solely qualified as tainted income because of the circumstances of the transactions, and which may therefore very well include income from non-capital intensive activities.

In comparison, the following important differences and common elements can be identified:

- The transactional countries Germany, Spain and Lithuania apply base company rules which do not focus on specific types of income but which are linked to the circumstances of the transactions. Such an approach opens the possibility of extending the CFC taxation to income which is usually considered “active” income (or non-passive income), i.e. all types of services (Germany, Spain and Lithuania) and even trading activities (Germany, Lithuania). This is an important difference to the transactional country

[71] Frobert, Danish Official Proposes New Rules on CFC Taxation, Tax Analysts Tax Document Service 2001, Doc. 2001-28851; Dietz / Buxbom, New Less Restrictive CFC Legislation, European Taxation 2002, page 515 et seq.
[72] PricewaterhouseCoopers LLP, Danish Parliament Approves Corporate Tax Incentives, Tax Analysts Tax Document Service 2002, Doc. 2002-12665.

Denmark, where only pre-defined financial income is subject to CFC taxation and a re-qualification of "active" income - just because of the circumstances of the transactions - does not take place.

- The German and Lithuanian base company rules provide requirements with respect to the organisation of the CFC. In Germany, it is the requirement of a "qualified business" and in Lithuania it is (only) the requirement of a sufficient number of personnel to carry out the activities of the CFC. Thus, in both cases the activities must be sufficiently organised in order to be outside of the current taxation of income. Spain and Denmark do not have similar requirements.

- The transactions with related parties are one of the core elements in all of the countries which apply base company rules. In Spain and Lithuania there is an explicit threshold for related party transactions: if more than 50 percent of the income of the CFC is derived from transactions with non-related parties, the base company income will not be subject to CFC taxation.[73] In Germany, there is no such explicit threshold, but the requirement of a "qualified business" makes it necessary to carry out transactions with non-related parties. However, there is clearly no strict and explicit requirement in Germany to derive income from non-related party transactions. In Denmark, an exemption is granted for income from certain financial activities, provided that the CFC conducts business mainly with customers in its own country of residence and mainly with third parties.

- The Spanish base company rules provide for an explicit requirement that the services are tax deductible for Spanish residents. In other words, only if the services provided by the CFC result in a tax deduction in Spain, the income will be subject to CFC taxation. This, of course, provides for (i) a clear concept which (ii) focuses on *direct* tax base reductions. Neither Germany nor Lithuania and Denmark have a comparably clear regime. Of course, the latter regimes equally focus on transactions towards resident taxpayers, but did not establish a comparable limitation. In essence, this results in a broader concept in Germany, Lithuania and Denmark which encompasses also *indirect* tax base reductions (or erosions), e.g. if the CFC provides services to recipients outside of the state which applies the CFC legislation. However, in case of Denmark the concept is limited to financial services (and financial income).

- Spain and Lithuania both provide for a direct dependence between non-tax deductible expenses under the domestic legislation and (corresponding) CFC income. That means if the expenses are not tax deductible, the corresponding CFC income will not be attributed to the domestic shareholder. Such a direct link does not exist under the German and Danish rules.

- Lithuania establishes a concrete maximum percentage of 10 percent for income derived by the CFC from sources outside of the state of residence of the CFC. Thus, the income will be subject to CFC taxation if the 10 percent threshold is exceeded. A comparable strict approach neither exists in Germany nor in Denmark and Spain.

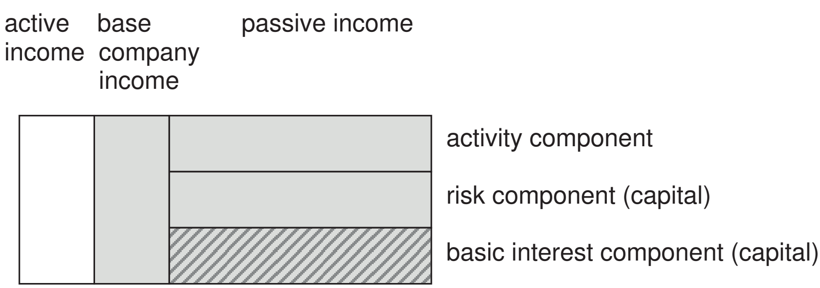
[73] But only if all other existing requirements are fulfilled as well (see above for further details). Of course, the explicitly marked passive income will still be subject to current taxation under the transactional approach CFC regimes.

- Overall, it seems that the transactional approach CFC countries Germany, Spain and Lithuania see the necessity to somehow "build a bridge" - with their base company rules - to the concept which is underlying an entity approach CFC legislation. In other words, it seems that it is not sufficient for Germany, Spain and Lithuania to provide for a mere categorisation according to the type of income, i.e. a strict separation according to pre-defined active and passive income. The latter is only the case in Denmark. Hence, one can certainly conclude that the base company rules come very close to the entity approach CFC rules. However, this will become more obvious below when the entity approach CFC rules will be examined.

6.2.2.3. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The base company rules, as a part of the transactional approach CFC legislation, are a clear deviation from the concept of a strict concentration on specific types of income (passive income). These rules determine the *circumstances* for the provision of services instead of the *types of income* as the connecting point for the application of the CFC regimes. This is true for the transactional countries Germany, Spain and Lithuania. It is obvious that such an approach extends the application of CFC regimes far beyond the capital intensive services which were described in this chapter and in previous chapters and which are usually qualified as passive activities (and income). However, the conclusion drawn from previous chapters is that the current taxation of income should be strictly limited to the basic interest component included in the separable financing element, i.e. after a horizontal and a vertical separation of income. If the services provided by the CFC do not include such a separable financing element, there is no reason and no basis for the current taxation of income. For this reason, the base company rules lead to a broadening of the transactional approach CFC regimes and to an application to income which should not be in the scope of the latter regimes.

<u>Figure 2:</u>



<u>Explanations:</u>

(1) "Income block" divided into active income, base company income and passive income (horizontal) and into the three different income components which are of importance for capital intensive activities (vertical). The vertical separation of the active income / base company income is not required,

because no element is included which should be subject to the current taxation of income in the state of the shareholder.
(2) Assumption: passive income = tainted income under the concept of basic interest taxation.
(3) White area: not subject to income allocation.
(4) Grey area: subject to income allocation under a transactional approach CFC taxation (including taxation under the base company rules).
(5) Grey-striped area: subject to income allocation under transactional approach CFC taxation and under the concept of basic interest taxation.
(6) The size of the horizontal and vertical "blocks" is just an assumption.

In my opinion, the base company rules clearly show that the CFC regimes are anti-avoidance regimes which do not follow - at least not foremost - economic and equity principles. In fact, it can even be argued that the base company rules of Germany, Spain and Lithuania bring the latter countries even further away from an acceptable approach - because the base company rules result in the attribution of income to the shareholder which should never be subject to a current taxation. In the figure shown above, it is not only the activity component and the risk component included in the passive income, but also the complete amount of base company income (unrelated to capital intensive services) which should not be attributed on a current basis to the shareholder.

In contrast thereto, Denmark does not apply base company rules like Germany, Spain and Lithuania, but strictly focuses on pre-determined financial income (passive income). In this respect, the Danish approach comes closer to the requirement of focusing on capital intensive activities if a separable financing element is included. However, even though the Danish approach goes in the right direction, the regime (still) merely provides for a horizontal separation of income but not for a vertical separation of income. For this reason, one must finally come to the conclusion that none of the transactional regimes fulfil the basic requirement of a strict horizontal and vertical separation of income.

6.2.2.4. Preliminary Conclusions

The base company rules are different from the explicitly marked income outlined earlier which is based on capital intensive activities. The base company rules are directed towards any other kind of services - and in case of Germany and Lithuania even trading activities - which are mainly carried on between related companies or where the domestic shareholder is somehow involved in the activities. That means even activities which normally do not lead to passive income by themselves are treated as tainted income under the base company rules if certain requirements are fulfilled. Thus, what is important here are the *circumstances* for the provision of services and not the *type* of services. This is very interesting, since it basically also targets the relocation and the concentration of business functions which do not require any substantial amount of capital investment. One should be aware that this is an important difference. As already outlined above, the involvement of large amounts of capital as such can lead to substantial profit allocations towards the low-tax jurisdiction, e.g. in case of finance activities, and the accompanying functions are often quite insignificant. This is totally different in situations where the capital investment does not play a comparably important role. In those cases, the functions exercised by personnel prevail. This does not mean that the activities have to be of great importance within the group or require highly skilled personnel, but it is clear that the functions are exercised from within the low-tax country and there is no obvious reason why the profit related to those functions (and risks) has to be allocated to the domestic shareholder. From a transfer pricing perspective, the profit related to the respective functions exercised (and risks taken) has to fulfil the arm's length requirements. Due to the absence of relevant capital investments, this is mainly related to the services provided by the personnel and it is - in my opinion - irrelevant whether the services are provided towards third parties or not and whether the domestic shareholder takes part in the providing of the services. The latter has, of course, to be taken into account by the determination of the arm's length consideration for the services.

Supposing a domestic parent company relocates certain administrative activities to a foreign subsidiary in a low-tax country. The personnel of the foreign company provides the services towards the parent company. The latter is therefore able to reduce its own personnel costs considerably since the domestic labour costs are higher than those in the foreign country. On the other hand, the outsourcing creates a different type of expenses due to the services provided by the subsidiary company. Since the services have to be provided on an arm's length basis, the service fees have to include a certain profit which reflects the functions exercised by the service provider and the risks taken. In the example, the profit would be relatively small since the function exercised is not very complex and the risks are comparably low. It could be the case that the overall expenses related to the services are lower than the saving of domestic labour costs. It is difficult to see a tax base erosion in such an example. Why should the profit of the service provider be allocated to the domestic parent company? The profit (and risk) element related to the administrative services is shifted from the parent company to the subsidiary company. There is no additional capital investment made or any other (intangible) value transferred. A profit allocation to the domestic shareholder has the effect that the income connection to the foreign activity is completely ignored - as if the functions were still exercised by the parent company. Clearly, the subsequent allocation of income according to the CFC rules is different from the allocation of income based on transfer pricing aspects. Logically, the transfer pricing aspects have to be verified first, and the CFC rules are applied on a totally different level, namely the level of the shareholder. However, the economic effect is the same: the income is taxed according to the rules and the tax rate of the residence country of the shareholder.

6.2.3. Conclusions Regarding the Transactional Approach

It is very clear that there is a substantial difference between the specifically outlined tainted (or passive) income which is related to capital intensive investments and the so-called base company income which covers any other kinds of activities and which are mainly carried on between related parties or where the domestic shareholder is somehow involved in the activities. The explicitly marked income, such as income from financing activities, portfolio activities, licensing activities and leasing activities, enables the parent company to invest a substantial amount of capital in the foreign country and to shift income related to the investment of capital from one country to another. This is not necessarily true for base company income. Here, even non-capital intensive investments are covered by the respective CFC rules with the effect that the profit related to personnel intensive functions and risks is attributed to the domestic shareholder. In my opinion, it is therefore important to separate the income elements included in the CFC income. Any income related to service activities exercised by personnel - irrespective whether it is an accompanying element of a capital intensive activity or the main (base company) activity - is related to functions carried on in the foreign country. In other words, the complete income is the result of an economic output created in the foreign country by the employment of personnel. Of course, this is different with respect to the employment of capital. A massive investment in a foreign country which allows the foreign subsidiary to give an inter-company loan to the parent company enables the foreign subsidiary to derive a substantial amount of income with a small number of employees and with a rather insignificant economic connection to the foreign country. The differentiation between capital intensive and non-capital intensive services seems to be important and necessary. The mere fact that services are provided towards a related party or the fact that a related party is somehow involved in the rendering of services should not be the decisive criterion.

If we look at the principles derived from chapters 2 and 3, it seems that the transactional approach - which focuses on the amount of passive income and base company income derived through the foreign company - is not in line with these principles. Even though the transactional approach separates income and does not take into account certain income from active businesses, it remains a merely horizontal separation of income, i.e. according to the type of income. In other words, the separation will still lead to an income allocation - and therefore to an income taxation according to the principle of capital export neutrality - of components which are produced in the CFC country. In general, this is true for passive income (such as for financing, licensing, leasing and renting income) and base company income. The transactional approach cannot provide for a vertical separation of income, i.e. a separation of income into risk components and the basic interest component, as it is required according to the principles derived from chapters 2 and 3.

6.3. The Entity Approach

In contrast to the transactional approach, the entity approach takes into account the overall activity of the CFC and certain other elements in order to decide whether the CFC is exempt from current taxation or not. It can therefore be seen as an "all-or-nothing" approach.[74] The Member States which follow such an entity approach CFC legislation are Estonia,[75] Finland,[76] France,[77] Hungary,[78] Italy,[79] Portugal,[80] Sweden[81]

[74] OECD, Controlled Foreign Company Legislation, Studies in Taxation of Foreign Source Income, 1996, page 48.

[75] See with respect to the Estonian CFC legislation Uustalu, Estonia: Estonia Introduces CFC Rules, Tax Notes International 2000, page 727 et seq.; Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 173 et seq.

[76] See with respect to the Finnish CFC legislation Juusela, Finland: An Amendment to the CFC Legislation, EC Tax Review 1999, page 88; Helminen, Finnish Tax Board Releases CFC Blacklist, Tax Notes International 1999, page 2317; Juusela, National Report Finland, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 479 et seq.; Pahapill, Estonia: Finnish CFC Regime Not a Threat, Officials Say, Tax Notes International 2003, page 1015 et seq.; Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 191et seq.; Schönfeld, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht, 2005, page 561 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, pages 271, 272. See chapter 7 with respect to the *A Oyj Abp* Case and the references to the respective tax literature. Further references related to the Finnish CFC rules are included in the bibliography.

[77] See with respect to the French CFC legislation Douvier, National Report France, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 495 et seq.; Kabbaj / de la Bletière, National Report France, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 221et seq.; D'Hont, France: Sweeping Tax Changes Affecting In/Outbound Investments, Tax Planning International Review 2004;

and the United Kingdom.[82] The focus here is not on the explicit classification and taxation of certain income, i.e. active or passive income, but on the overall

Goulard / Jolly, French Lawmakers Revisit CFC Rules, Tax Notes International 2005, page 219 et seq.; Gouthière, French Anti-Abuse International Tax Legislation: Recent Developments, European Taxation 2006, page 514 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, pages 267, 268; Gouthière, Overview of the French CFC Legislation, European Taxation 2008, page 50 et seq. See chapter 7 with respect to the *Schneider* Case and the references to the respective tax literature. Further references related to the French CFC rules are included in the bibliography.

[78] See with respect to the Hungarian CFC legislation Sandler, Tax Treaties and Controlled Foreign Company Legislation - Pushing the Boundaries, Second Edition, 1998, pages 239, 240; Deák, National Report Hungary, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 549 et seq.; Liszicza, National Report Hungary, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 303 et seq.

[79] See with respect to the Italian CFC legislation Giuliano, National Report Italy, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 615 et seq.; Favi, National Report Italy, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 349 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, pages 277, 278; Rossi, Italy Introduces Corporate Tax Residency, Anti-Inversion Rules, Tax Notes International 2006, page 699 et seq.; Rossi, Ruling on the Application of the Italian CFC Rules to a Maltese International Trading Company, European Taxation 2006, page 131 et seq.; Pacelli, The Application of Italian CFC Rules to Maltese Subsidiaries, Tax Notes International 2006, page 153 et seq.; Ferrol / Queiroli, Italy: Italy's CFC Rules Applicable to EU Companies, Tax Administration Says, Tax Notes International 2006, page 269; Galli, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Italy, International Transfer Pricing Journal 2008, page 44 et seq.; Peracin / De Luca, Applying CFC Rules to 'Affiliates': Critical Elements for Consideration, Intertax 2008, page 18 et seq. Further references related to the Italian CFC rules are included in the bibliography.

[80] See with respect to the Portuguese CFC legislation Cunningham, Portugal: Portugal Introduces CFC Legislation, Tax News Service 1995, page 111; Dourado, Portugal: Anti-Abuse Clauses, EC Tax Review 1995, page 273; de Sousa da Camara, / Ayala, Portugal: CFC Taxation, European Taxation 1996, page 21 et seq.; Teixeira de Abreu, Controlled Foreign Corporation Legislation in Portugal, Tax Planning International Review 1997, page 17 et seq.; Sandler, Tax Treaties and Controlled Foreign Company Legislation - Pushing the Boundaries, Second Edition, 1998, pages 256, 257; de Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 767 et seq.; de Sousa da Camara / Núncio, Portugal's 2002 Budget Bill Revises Capital Gains Tax Regime, Tax Analysts Tax Document Service 2001, Doc 2001-28988; Borges, National Report Portugal, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 527 et seq. Further references related to the Portuguese CFC rules are included in the bibliography.

[81] See with respect to the Swedish CFC legislation Dahlberg, National Report Sweden, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 827 et seq.; Mutén, Sweden's CFC Rules Under Change, Tax Notes International 2003, pages 216, 217; Hansson / Nilsson, Sweden: Government Proposes New CFC Rules, Tax Notes International 2003, page 998; Mutén, Sweden: Law Council Critical of Proposed CFC Legislation, Tax Notes international 2003, page 1319 et seq.; Björkeson, The New Holding Company Regime in Sweden, Tax Planning International Review 2004, page 15 et seq.; Koehlmark / Kaellqvist, New CFC Legislation in Sweden, Bulletin for International Fiscal Documentation 2004, page 225 et seq.; Dahlberg, National Report Sweden, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 581 et seq.; Mutén, Sweden: Council for Advance Tax Rulings Upholds CFC Legislation, Tax Notes International 2005, pages 209, 210; Brokeling, Group Taxation and CFC Rules in Swedish Tax Cases, Tax Notes International 2005, page 237 et seq.; Pihlgren, A Break With Tradition, International Tax Review 2007, pages 62, 63. Further references related to the Swedish CFC rules are included in the bibliography.

[82] See with respect to the United Kingdom CFC legislation Friel, National Report of the United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 869 et seq.; Ullah, National Report United Kingdom, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 605 et seq.; Schönfeld, The Cadbury Schweppes Case: Are the Days of the United Kingdom's CFC Legislation Numbered?, European Taxation 2004, page 441 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, pages 269, 270; Hume / Seinsche, Court Demands CFC Rules Rethink, International Tax Review 2006, page 27 et seq.; Sams / Patel, A Dash for the Exit?, The Tax Journal 2006, pages 17, 18; Moss / Gillham, Controlled

classification of the foreign company. It is therefore necessary to examine the exemptions from current taxation to understand the main aspects of the entity approach.

6.3.1. The Various Exemptions under the Entity Approach

6.3.1.1. Exemption Based on the Activity of the CFC

The activity of the CFC is one of the decisive criteria for the question whether the foreign entity should be subject to CFC taxation or not. Even though there is no direct active-passive separation of income under this approach, it can be seen as an overall assessment of the foreign company's activities. In order to qualify for an exemption from current taxation, there are - in my opinion - three elements which are of particular importance:

- the type of business activity
- the source of CFC income
- the extent of business activity

a.) The type of business activity

In general, the carrying on of mainly active business is an important criterion for most of the Member States which follow an entity approach. In Estonia, the CFC rules are not applicable if more than 50 percent of the income of the foreign entity is derived from active business such as the manufacturing of goods, trade, provision of transport, communication, accommodation and tourism services in the residence country of the foreign entity, chartering of freighting vessels as well as certain insurance services.[83] In Finland, the CFC is required to derive its income mainly from industrial activity, any other comparable production activity or shipping activity in its country of residence, or - under certain circumstances - sales and marketing activities which directly serve a company conducting one of the aforementioned business

Foreign Company Legislation and the Abuse of Law, Tax Planning International Review 2006, page 3 et seq.; Casley / Webb-Martin, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: United Kingdom, International Transfer Pricing Journal 2007, page 341 et seq.; MacLachlan / Fairley, UK Proposes Changes to Foreign Profits Taxation, International Tax Review 2007, page 26 et seq.; Gershuny / Israel / Borzumato / Dörr, Impact of Cadbury Schweppes on CFC Legislation, Tax Planning International Review (January) 2007; O'Shea, The UK's CFC Rules and the Freedom of Establishment: Cadbury Schweppes PLC and its IFSC Subsidiaries - Tax Avoidance or Tax Mitigation?, EC Tax Review 2007 page 13 et seq.; Morgan / Munro, Under Control?: Taxation of Foreign Profits, The Tax Journal 2007, page 7 et seq.; Whitehead, Practical Implications Arising from the European Court's Recent Decisions Concerning CFC Legislation and Dividend Taxation, EC Tax Review 2007, page 176 et seq.; Ronfeldt / Vinther / Werlauff, CFC Rules Go Up in Smoke – with Retroactive Effect, Intertax 2007, page 45 et seq.; Persoff, HMRC Revised Draft Guidance on Controlled Foreign Companies Rules, EC Tax Review 2008, page 96. The *Bricom Holdings* Case will be discussed in the following chapter. The *Cadbury Schweppes* Case is outlined in chapter 4 and will also play a role in chapter 8. The references to tax literature dealing with these two cases are included in the respective chapters. Further references related to the United Kingdom CFC rules are included in the bibliography. The legislative changes made after the *Cadbury Schweppes* decision and the HM Treasury / HM Revenue & Customs proposals are outlined in chapter 8.

[83] Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 178, 179. However, it is important to mention that the Estonian CFC taxation is applicable to resident individuals only (see Uustalu, page 176).

activities.[84] In France, the controlling legal entity must demonstrate that the foreign entity effectively carries on a commercial or industrial activity, conducted from its country of establishment or registered office (under the former rules, the cave-out only applied if the activities were "primarily carried out on the local market"). An exemption from French CFC taxation will not be applicable if a significant part of the profits of the foreign entity is derived from passive income. This is the case (i) if more than 20 percent of the income of the CFC is derived from the management of financial assets and the exploitation of rights to intangibles, or (ii) if more than 50 percent of the income of the CFC is derived from certain other activities, such as the provision of inter-company services. In those cases, the French company can only be exempt from CFC taxation if it can demonstrate that the allocation of profits to the country with a privileged tax regime is not the main purpose of the structure.[85] In Italy, it is necessary that the foreign company exercises mainly an effective industrial or commercial activity.[86] In Portugal, at least 75 percent must be derived from an agricultural, industrial or commercial activity. Interestingly, the Portuguese legislation excludes certain activities from the active industrial or commercial activities of the CFC and therefore builds a bridge to the active-passive definitions of the transactional countries. The foreign company's main business must not comprise operations such as banking activities, insurance activities (under certain circumstances), holding of participating interests or other securities, intellectual or industrial property rights, or rights relating to know-how or technical assistance, and the renting out of assets, except immovable property situated in the foreign company's country of residence.[87] The United Kingdom - with the most extensive list of exemptions - applies an "exempt activities test" for foreign companies with mainly trading activities and holding companies deriving the substantial majority of their income as dividends directly or indirectly from exempt trading companies.[88] Thus, it can be concluded that most of the countries which follow an entity approach require the CFC to carry on mainly industrial or commercial activities in order to be outside of the scope of CFC taxation. Hence, the mere focus on inter-company services - which would otherwise be classified as tainted activities or base company activities under the transactional approach CFC regimes - would therefore typically also result in an income attribution under the above entity approach regimes. The Swedish approach is clearly an exception. In Sweden, the type of income is - in general - not decisive, i.e. the Swedish rules not only focus on income from passive activities but also

[84] Section 2 (2) of the Finnish CFC Act; see also Grünbaum, Finland: CFC Rules to be Revised, Tax News Service 1998, page 376; Helminen, Finnish Government Proposes Changes to New CFC Regime, Tax Notes International 1998, page 1431; see in this respect also the FEE Position Paper, April 2002, page 41.

[85] New Article 209 B of the French Tax Code; see Simmons & Simmons, EU Tax Update, January 2005, page 3; Herbert Smith, New Controlled Foreign Company ("CFC") Rules, French Tax Briefing, January 2005, page 6; Ippolito / Pontnau-Faure, France: CFC Rules Reform, Tax Planning International Transfer Pricing 2005, page 10; with respect to the former rules see Bérengier, French Administrative Supreme Court Holds that Tax Treaties Override French CFC Rules, Tax Planning International Review 2002, page 3; Mbwa-Mboma, Treaty With Switzerland Overrides French CFC Legislation, French High Tax Court Confirms, Tax Analysts Tax Document Service 2002, Doc 2002-15647; see also the FEE Position Paper, April 2002, page 9; Regulations 4H-3-98 of April 17, 1998, nos. 198-202.

[86] Section 127 (5)-bis of the Italian Corporate Income Tax Act. See also Perin, Italy: Italian Ministry of Finance Explains Controlled Foreign Company Rules, Tax Notes International 2001, page 617 et seq.; Tognolo, New Controlled Foreign Corporations (CFC) Rule in Italy, Tax Planning International Review 2001, page 9.

[87] Section 57-B of the Portuguese Corporate Income Tax Act; de Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 779, 780; de Sousa da Camara / Núncio, Portugal's 2002 Budget Bill Revises Capital Gains Tax Regime, Tax Analysts Tax Document Service 2001, Doc 2001-28988.

[88] Friel, National Report of the United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 881.

encompass income from active businesses if other requirements - such as low-taxation and a certain percentage of shareholding - are fulfilled.[89] However, when it comes to the exemption from Swedish CFC taxation, an active-passive separation plays a role, too.[90] Thus, it seems that states which follow an entity approach also use elements which are typically applied in the context of a transactional system. It seems to me that this is considered to be necessary for a "fine-tuning" of the legislation, e.g. in case of France, Portugal, and Sweden.

b.) The source of CFC income

It is often not sufficient simply to carry out an active business in the sense of the definition provided by the respective legislation, but additional requirements which are related to the source of the CFC income must be fulfilled in order to qualify for an exemption from CFC taxation. In Finland, the industrial activity, any other comparable production activity or shipping activity must be connected to the country of residence of the CFC. An exemption from CFC taxation will also apply if the foreign company's income is mainly derived from sales and marketing activities which directly serve a company conducting one of these areas of activity and which are mainly directed to the territory of the country of residence. The foreign company is not deemed to be a CFC if its income is mainly derived from payments made by a limited liability company within the same group which is resident in the same country as the foreign company in question and conducts one of the industrial activities mentioned above there.[91] In France, the already existing safe harbour provision has been expanded so that a deemed transfer of profits does not take place if the activities of the foreign entity are carried out in the state in which it is located.[92] The Hungarian CFC legislation requires a "real economic presence" in the country of the foreign entity in order to be exempt from CFC taxation.[93] In Italy, the foreign company must carry out as its main business an effective industrial or commercial activity in the state or territory where it is established.[94] The Portuguese legislation requires the business activities outlined above to be exercised without the involvement of Portuguese residents. However, the activity is exempt from Portuguese CFC taxation - even though Portuguese residents participate in such activities - as long as the commercial

[89] See with respect to the revised Swedish CFC legislation: Delphi & Co., New CFC legislation introduced in Sweden, December 2003, page 1; Koehlmark / Kaellqvist, New CFC Legislation in Sweden, Bulletin for International Fiscal Documentation 2004, pages 225-232; Mutén, Sweden's CFC Rules Under Change, Tax Notes International 2003, pages 216-217; PricewaterhouseCoopers, Swedish Capital Gains, CFC Rule Changes Still in the Works, Tax Analysts Tax Document Service 2002, Doc 2002-3867.

[90] Sweden applies a so-called "white list" which excludes legal entities in certain countries from being subject to the Swedish CFC rules. However, there are certain types of activities which might not be subject to said exemption even though the entity is covered by the white list. Such businesses are normally insurance-, bank-, financial-, and offshore business (Andulf Advokat AB, Sweden Tax and Legal Developments, January 2004).

[91] Section 2 (2) of the Finnish CFC Act.

[92] New Article 209 B of the French Tax Code; see Herbert Smith, New Controlled Foreign Company ("CFC") Rules, French Tax Briefing, January 2005, page 6; Tillmanns, Steueränderungen Frankreich 2004/2005, Internationale Wirtschafts-Briefe, Fach 5, Gruppe 2, page 1417 et seq. (1420); see with respect to the former CFC rules: Bérengier, French Administrative Supreme Court Holds that Tax Treaties Override French CFC Rules, Tax Planning International Review 2002, page 3; see also FEE of April 2002, page 9; section 209 B-II of the French Tax Code; Regulations 4H-3-98 of April 17, 1998, nos. 198-202.

[93] However, the meaning of a "real economic presence" has not been further clarified (Liszicza, National Report Hungary, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 309).

[94] Section 127 (5)-bis of the Italian Corporate Income Tax Act; see Gazzo, Italy's CFC Legislation Implemented and Participation Exemption Extended, IBFD Bulletin 2002, page 77 et seq. (83).

activity is predominantly directed towards the foreign company's local market.[95] Under the United Kingdom exempt activities test it is required that the CFC has a substantive presence in its country of residence and mainly carries on genuine trading activities in that country. Certain sales, financial or other service companies whose business is mainly with related parties or with the United Kingdom are excluded from the exemption. The exemption also applies to holding companies deriving the substantial majority of their income as dividends directly or indirectly from exempt trading companies. Furthermore, the CFC must have a business establishment in its territory of residence and its business must be effectively managed there.[96] There are detailed conditions for trading companies and holding companies which must in addition be satisfied.[97] All of the states mentioned above provide for an exemption from CFC taxation if the foreign company carries on its activities mainly (see below) in the state where the CFC is established. In other words, the providing of merely domestic services (in the state of the CFC) is considered to be a situation which - pursuant to the legislation outlined above - should not result in an immediate income allocation. Although such an approach is not self-evident because it may also lead to a sheltering of income from domestic taxation the risk of tax avoidance is apparently seen as lower than in a cross-border situation (in combination with the other factors - especially the type of business activity). However, from the perspective of a state which follows the principle of capital export neutrality, there is no difference between services provided by the CFC towards recipients in the CFC state or towards recipients in other (third) states.

c.) The extent of business activity

It is clear from the explanations above that the business activities which are subject to exemption from CFC taxation have to comprise a major part of the activities of the CFC. Most often the term "mainly" is used to describe the necessary extent of business activities. However, it is important to recognise that the term "mainly" is normally not only connected to the respective activity as such but also to the respective local market. In France, the income will not be attributed if the activities are carried out in the state in which the foreign entity is located. The former French CFC rules required that the activities were "primarily" carried out on the local market. The new rules now focus on a passive income test. Based on the test, certain income from passive activities must not exceed 20 percent (the management of financial assets and the exploitation of rights to intangibles) or 50 percent (certain other activities, such as inter-company services), respectively.[98] In Finland, the term "mainly" has to be understood as more than 50 percent,[99] and in Portugal it is at least 75 percent of the income of the CFC.[100] Therefore, an exemption based on a certain

[95] Section 57-B of the Portuguese Corporate Income Tax Act; de Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 779, 780.
[96] Friel, National Report of the United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 881.
[97] Friel, National Report of the United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 882-886.
[98] New Article 209 B of the French Tax Code; see Simmons & Simmons, EU Tax Update, January 2005, page 3; Herbert Smith, New Controlled Foreign Company ("CFC") Rules, French Tax Briefing, January 2005, page 6; Tillmanns, Steueränderungen Frankreich 2004/2005, Internationale Wirtschafts-Briefe, Fach 5, Gruppe 2, page 1417 et seq. (1420); see with respect to the former CFC rules: Regulations 4H-3-98 of April 17, 1998, nos. 198-202.
[99] Section 2 (2) of the Finnish CFC Act.
[100] Section 57-B of the Portuguese Corporate Income Tax Act.

business activity requires at the same time that the activity encompasses a substantial part of the activities of the CFC, i.e. normally more than 50 percent.[101]

6.3.1.2. Exemption Based on a Motive Test

The United Kingdom provides for an exemption from CFC taxation based on a motive test. In order to qualify for this exemption, the reduction of domestic tax must not be the main purpose for a certain transaction and it must not be one of the main reasons for the existence of the CFC to achieve a reduction in United Kingdom tax by a diversion of profits from the United Kingdom. The Inland Revenue provided examples of typical cases where the motive test is regarded as satisfied:

- if the business could not have been carried on by a United Kingdom resident;
- if there are "sound commercial reasons" for using a locally resident company rather than a branch of a United Kingdom resident company;
- if the CFC exists to avoid foreign tax and not United Kingdom tax. This would be the case if a foreign group with a pre-existing CFC were taken over by a United Kingdom resident company.[102]

In my opinion, a motive test makes some sense since CFC legislation must be seen as an anti-avoidance legislation. However, the subjectivity which is inherent in such a motive test can lead to a great uncertainty for the taxpayer. In contrast, detailed rules which can give the motive test objectivity can have the effect of an immense complexity of the CFC rules.[103] The French CFC legislation also includes a general motive test according to which a French resident company may demonstrate that the foreign company was not established to localise profits in a tax privileged country.[104]

6.3.1.3. Exemption Based on an Acceptable Distribution Policy

An exemption based on an "acceptable distribution policy" - like in the United Kingdom - seems to be a logical and obvious exemption from CFC taxation.[105] Since the CFC taxation is directed towards the avoidance of income deferral in low-tax countries, a subsequent distribution which occurs (i) a short time after the end of the fiscal year of the foreign company and (ii) which is taxable in the residence state of

[101] The same is true for Estonia where more than 50 percent is required – even though the CFC rules are limited to resident individuals (see Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 178).

[102] Friel, National Report of the United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 888; Section 748 (3) of the United Kingdom Corporate Income Tax Act.

[103] See in this respect OECD, Controlled Foreign Company Legislation, Studies in Taxation of Foreign Source Income, 1996, page 75.

[104] New Article 209 B of the French Tax Code; see Simmons & Simmons, EU Tax Update, January 2005, page 3; Herbert Smith, New Controlled Foreign Company ("CFC") Rules, French Tax Briefing, January 2005, page 6; Tillmanns, Steueränderungen Frankreich 2004/2005, Internationale Wirtschafts-Briefe, Fach 5, Gruppe 2, page 1417 et seq. (1420); the former French CFC rules were slightly different in this respect, see Bérengier, French Administrative Supreme Court Holds that Tax Treaties Override French CFC Rules, Tax Planning International Review 2002, page 3; see also FEE of April 2002, page 9.

[105] See with respect to the United Kingdom: Mongan / Bussey, Managing the Ever-Changing Controlled Foreign Company Rules, Tax Planning International Review 2002, page 3 et seq.; Inland Revenue REV BN 21, Loophole Closed in Controlled Foreign Company Rules, on the internet: http://www.inlandrevenue.gov.uk/budget2001/revbn21.htm; Leegaard, CFC Legislation - Recent Changes to the Acceptable Distribution Policy Exemption, European Taxation 2001, page 293 et seq.

the shareholder will eliminate the attractiveness of the income deferral. The subsequent distribution will always lead to an increase of the tax rate up to the level of the state of the shareholder within a short period of time, i.e. the positive effects of deferral cannot be used in such a situation. However, this is only true to the extent that the profit distribution is taxable in the state of the shareholder, like in the United Kingdom, and not exempt from taxation, e.g. through the application of a participation exemption. In the latter case, where the profit distribution is exempt from taxation, there is no subsequent increase in the income taxation to the domestic level. Hence, if an exemption from CFC taxation shall be granted on the basis of an acceptable distribution policy, it is logically required, in my opinion, that the profit distribution is subject to income taxation in the residence state of the shareholder (parent company). In principle, it does not matter whether the taxation is based on the regular tax credit system of the residence state of the shareholder, like in the United Kingdom, or on the basis of a system which switches from the exemption method to the credit method under certain circumstances. Theoretically, it is possible to apply a CFC regime and, in addition thereto, a regime which provides for a taxation of profit distributions of companies which carry on certain (passive) activities (but where the previous income attribution under the CFC regime is taken into account for subsequent distributions). In this case, an acceptable distribution policy can, of course, be a reason for an exemption from CFC taxation. However, this requires two complex systems which are partly dependent on each other. I think that in those cases it might be better to concentrate on CFC taxation - and therefore the current taxation of income - than to implement two complex systems which have, at the end, a similar focus - namely the domestic taxation of income which is derived from certain activities but not from all activities. Overall, it can be concluded, in my opinion, that an exemption from CFC taxation which is based on an acceptable distribution policy makes sense only if the subsequent distribution is subject to income taxation in the hands of the recipient of the dividend payment.

6.3.1.4. Exemption for Publicly Traded Companies

Another possibility to avoid the application of CFC taxation is the exemption for publicly traded companies. The United Kingdom offers such an exemption under certain - quite restrictive - circumstances.[106] In France, there is also a specific provision which is applicable to publicly listed companies: for the question whether the participation threshold is exceeded, the French tax authorities have to demonstrate that the French controlling legal entity, together with other entities holding shares in the foreign legal entity, are acting in concert. If this cannot be demonstrated by the tax authorities, the French CFC rules cannot be applied.[107] An exemption from CFC taxation also exists in Germany - which is a transactional country - for shares in a CFC which are quoted on a stock exchange and which are traded “regularly and considerably.”[108]

The idea behind an exemption for listed companies could be the fact that a publicly traded company is normally owned by a great number of shareholders and the public listing causes an additional administrative, legal and financial burden, and it is therefore rather unlikely that such a structure is used for the avoidance of domestic

[106] Outside of Europe only Israel has a comparable exemption (see Arnold / Dibout, Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 62).
[107] New Article 209 B of the French Tax Code.
[108] Section 7 (6a) of the German Foreign Tax Act.

taxation.[109] Pursuant to the OECD, the rationale for the exemption is that a company with a significant proportion of its shares held by the general public would be under commercial constraints to pursue an acceptable distribution policy, and so it is much less likely to be used as an avoidance vehicle for a group of companies.[110]

6.3.1.5. Exemption Based on a Certain Threshold

A certain threshold is sometimes applied to avoid the attribution of minor amounts of passive income to the domestic shareholder (*de minimis* exemption). The exemption is mostly due to administrative convenience and simplification. In principle, this should be equally relevant for countries which follow an entity approach and a transactional approach. Denmark, which is a transactional country, applies a relatively high threshold for financial income. It will only be attributed to the Danish shareholder if it exceeds one-third of the total net income of the CFC calculated pursuant to Danish rules. Based on that rule, a substantial amount of passive income can be excluded from CFC taxation.[111] In Germany, a transactional country, the exemption provision requires, under certain circumstances, that a certain percentage *and* an absolute amount is not exceeded.[112] In case of countries which follow an entity approach, it is the United Kingdom which provides for an exemption from CFC taxation if the income of the CFC is below a certain absolute amount.[113] In France, the revised CFC legislation provides for an additional threshold (percentage) in the context of the passive income test.[114]

6.3.1.6. Exemption Based on an Excluded Country List

An excluded country list - or “white list” - is sometimes used to determine the countries or territories which shall be outside of the scope of CFC taxation.[115] The United Kingdom is one of those countries which apply such an excluded country list. However, the listing does not automatically lead to an exclusion from CFC taxation since several other aspects have to be fulfilled, such as a “local source income” condition.[116] Here, the excluded country list can give an overview of those countries which are generally not considered to be CFC countries but further verifications are necessary. In Sweden, the excluded country list is of great importance since the

[109] See with respect to the United Kingdom: Friel, National Report of the United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 889.
[110] OECD, Controlled Foreign Company Legislation, Studies in Taxation of Foreign Source Income, 1996, page 75.
[111] Frobert, Danish Official Proposes New Rules on CFC Taxation, Tax Analysts Tax Document Service 2001, Doc. 2001-28851; Dietz / Buxbom, New Less Restrictive CFC Legislation, European Taxation 2002, page 515 et seq.
[112] See, for example, the German rules with respect to income of a capital investment kind. The maximum amount is stipulated with 10 percent of the “gross income” and 62.000,00 Euro (section 7 (6) of the German Foreign Tax Act).
[113] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 61.
[114] Simmons & Simmons, EU Tax Update, January 2005, page 3; Herbert Smith, New Controlled Foreign Company (“CFC”) Rules, French Tax Briefing, January 2005, page 6.
[115] See in this respect also Kaufmann, Controlled Foreign Companies (CFC)-Gesetzgebung - Übersicht über die Rechtslage in den EU-Mitgliedstaaten, Steuer und Wirtschaft International 2001, page 16 et seq. (17).
[116] See Mongan / Bussey, Managing the Ever-Changing Controlled Foreign Company Rules, Tax Planning International Review (September) 2002, page 3 et seq.; Friel, National Report of the United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 872, 873.

Swedish CFC taxation does not differentiate between active and passive income, i.e. both can be subject to CFC taxation. However, if Sweden has entered into a tax treaty with a state on the list, the treaty must encompass the income of the foreign entity.[117]

6.3.2. Concepts Similar to Entity Approach CFC Legislation

In principle, the Dutch legislation on participation exemption is usually not considered to be a CFC regime - at least not in the narrower sense.[118] However, the fact that such legislation may result, under certain circumstances, in an annual mark-to-market revaluation of the investment makes it worth to have a closer look at these rules, too. Under Dutch legislation, the mark-to-market revaluation only applies to certain investments in passive low-taxed participations with a minimum shareholding of 25 percent.[119] However, the mark-to-market revaluation is only made if the assets of that entity exclusively or almost exclusively, directly or indirectly, consist of "free investments."[120] This seems to be the case if 90 percent or more of the assets consist of free investments.[121] The latter investments are defined as other investments than those reasonably required by the business activities of the entity holding the investments.[122] Free investments include assets which are used for activities which mostly consist of direct or indirect financing of the taxpayer or of entities related to the taxpayer, or assets of the taxpayer or entities related to the taxpayer, including the making available of assets for use or a right of use of assets, unless it is likely that the activities of the entity in which the taxpayer holds a participation can be treated as active financing activities under rules to be determined by ministerial decree.[123]

The fact that the mark-to-market revaluation is applied to the complete participation of the shareholder, without any separation of the activities, brings the legislation, in

[117] See Delphi & Co., New CFC legislation introduced in Sweden, December 2003, page 1; Koehlmark / Kaellqvist, New CFC Legislation in Sweden, Bulletin for International Fiscal Documentation 2004, pages 225-232; Muten, Sweden's CFC Rules Under Change, Tax Notes International 2003, pages 216-217. However, there are certain types of activities which might not be subject to the exemption even though the entity is covered by the white list. Such businesses are normally insurance-, bank-, financial-, and offshore business (see Andulf Advokat AB, Sweden Tax and Legal Developments, January 2004).

[118] See with respect to the Dutch participation exemption regime Articles 13, 13a and 23c of the Dutch Corporate Income Tax Act; see with respect to the revised Dutch participation exemption regime also Kinnegim, Netherlands: Year in Review, Tax Notes International 2006, page 1082 et seq.; van Wettum / Bevers / van Minnen, The Netherlands: Corporate Income Tax Reform 2007, Tax Planning International Review 2006, page 12 et seq.; Habers, New Dutch Tax Legislation Precursor to Favourable 2007 Corporate Income Tax Reforms, Tax Planning International Review 2006, page 19 et seq.; Bakker / van de Rijt, Netherlands Corporate Income Tax Reform 2007 - Bill "Working on Profit", Bulletin for International Fiscal Documentation 2006, page 308 et seq.; van Dam, Dutch Corporation Tax Reform 2007 - Bill "Working on Profit" Submitted to Parliament, Tax Planning International European Union Focus (June) 2006; Zoetmulder, Dutch 2007 Tax Reform "Working on Profit" Approved by Upper House, Tax Planning International European Union Focus (December) 2006; Spierts, Steueränderungen in den Niederlanden, Internationale Wirtschafts-Briefe 2007, Fach 5, Gruppe 2, page 25 et seq.; Dikmans, New Netherlands Corporate Income Tax Provisions for 2007, European Taxation 2007, page 158 et seq.; Willeme / Schutz, Dutch Reforms can deliver for Investors, International Tax Review 2007, page 28 et seq,; van Helvoirt, Niederlande: Anwendungschreiben Schachtelprivileg, Internationales Steuerrecht, 2008, Länderbericht, pages 32, 33.

[119] See Articles 13 and 13a of the Dutch Corporate Income Tax Act.

[120] Article 13a (1) (a) of the Dutch Corporate Income Tax Act.

[121] Spierts, Steueränderungen in den Niederlanden, Internationale Wirtschafts-Briefe 2007, Fach 5, Gruppe 2, page 25 et seq. (28).

[122] Articles 13 (10) and 13a (1) of the Dutch Corporate Income Tax Act.

[123] Articles 13 (11) and 13a (1) of the Dutch Corporate Income Tax Act.

my opinion, closer to the entity approach CFC taxation than to the transactional approach CFC taxation. At first glance, it seems that the Dutch legislation provides a very high threshold in order to be applicable. However, one has to keep in mind that the “90 percent rule” refers to the assets and not to the income. Thus, if the capital intensive services, which are usually in the focus of CFC regimes, are combined with other (non-tainted) activities, the 90 percent threshold can be reached and exceeded very soon - and this does not even mean (or require) that the income of the passive activities prevails within the overall income of the subsidiary. In essence, the Dutch approach is to a certain extent different from the CFC regimes outlined above (e.g. the mark-to-market approach, the focusing on the assets instead of the income), but due to the fact that the approach includes the important elements of CFC taxation, namely the concentration on certain (passive) investments, the low-taxation requirement, the requirement of a minimum participation and, most important, the current taxation of income, it shall be included in the following sections.

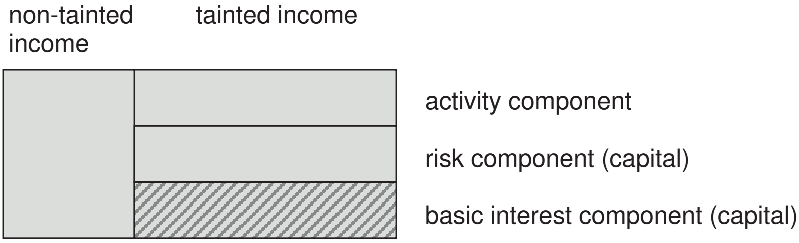
6.3.3. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

There is a substantial difference between a CFC regime which follows a transactional approach and a CFC regime which follows an entity approach. In the first-mentioned case, the CFC regimes focus on a separation of tainted income and non-tainted income with the result that only tainted income shall be subject to current taxation. Such a horizontal separation of income is also required, as a first step, if one follows a concept which is based on the taxation of the basic interest component. Even though I have criticised the way of horizontal separation of the transactional countries, it is a method intended to limit the current taxation to certain types of income. As I have mentioned earlier, the latter income is usually related to capital intensive activities which contain a separable financing element.

Of course, this conclusion cannot be transferred to the base company rules (as a part of the transactional system), because the base company rules can lead to the result that income which is usually considered “active” income becomes subject to current taxation. As already outlined earlier, this can easily result in the CFC taxation of income which has nothing to do with capital intensive activities and which does not include any separable financing element. For this reason, the combination of a current taxation of passive income and base company income may come very close to the outcome according to an entity approach CFC taxation. In this regard, there may still be a horizontal separation, but this separation does not, in essence, lead to an acceptable outcome. This is an important conclusion, given the fact that among the transactional countries outlined earlier it is only Denmark which does not follow a base company approach.

In contrast to the transactional approach CFC regimes, the entity approach CFC regimes do not follow such a concept of horizontal separation of income at all. Thus, the latter regimes neither provide for a vertical separation of income nor for a horizontal separation of income with the important consequence that the decisive prerequisites for the application of an efficient and target-oriented anti-avoidance (anti-deferral) legislation which is based on the current taxation of income are missing. In essence, this is equally true for regimes which follow an entity approach and those which follow a similar approach, e.g. the Dutch concept of mark-to-market revaluation under the participation exemption regime.

Figure 3:

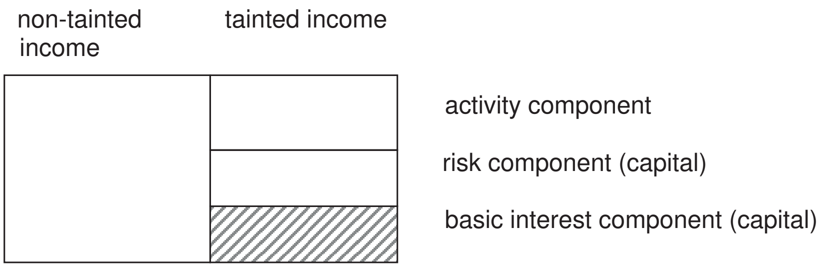


Explanations:

(1) “Income block” divided into non-tainted and tainted income (horizontal) and into the three different income components which are of importance for capital intensive activities (vertical). The vertical separation of the non-tainted income is not required, because no element is included which should be subject to the current taxation of income in the state of the shareholder.
(2) Assumption: passive activities under the CFC regimes = tainted activities under the concept of basic interest taxation. The CFC derives mainly tainted income.
(3) White area: not subject to income allocation (not relevant because the CFC derives mainly tainted income).
(4) Grey area: subject to income allocation under an entity approach CFC taxation
(5) Grey-striped area: subject to income allocation under an entity approach CFC taxation and under the concept of basic interest taxation.
(6) The size of the three income components is just an assumption.

The illustration shows that the concept of an “all-or-nothing” approach results not only in the current taxation of the activity component and the risk component included in the tainted income but also in the taxation of the non-tainted income, i.e. the income which should be completely exempt from any current taxation. This, of course, is an unacceptable approach from an economic perspective and an equity perspective. It was concluded earlier that the taxation should follow the principle of capital import neutrality - with the exception of the taxation of the basic interest component. However, in the example above, the entity approach leads to an undifferentiated taxation according to the principle of capital export neutrality. If the exemption from current taxation is solely linked to the existence of an “active” or “passive” activity carried out by the CFC, in my opinion no consistent and reliable concept of current income taxation exists. The activity will be taxed according to the principle of capital export neutrality in one case (if the “active” activity is a minor activity), but according to the principle of capital import neutrality in another case (if the “active” activity is a major activity). In essence, this leads to an over-taxation in the first-mentioned case and to an insufficient taxation in the second-mentioned case. This, of course, cannot be seen as an equal treatment of foreign investments.

Figure 4:



Explanations:

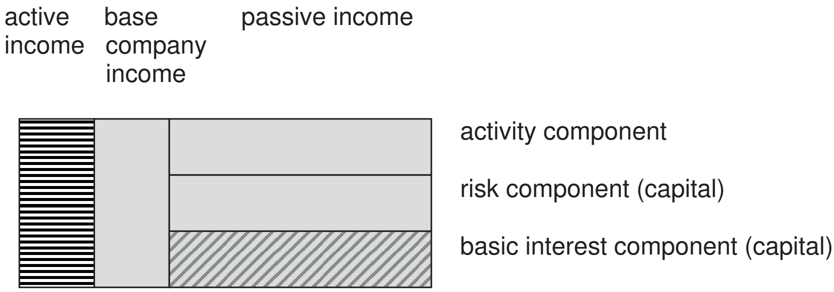
(1) "Income block" divided into non-tainted and tainted income (horizontal) and into the three different income components which are of importance for capital intensive activities (vertical).
(2) Assumption: passive activities under the CFC regimes = tainted activities under the concept of basic interest taxation. The CFC derives mainly non-tainted income.
(3) White area: not subject to income allocation.
(4) Grey area: subject to income allocation under an entity approach CFC taxation (not relevant because the CFC derives mainly non-tainted income).
(5) Striped area: subject to income allocation under the concept of basic interest taxation only.
(6) The size of the three income components is just an assumption.

It is important to recognise that the complete exemption from CFC taxation under the entity approach CFC regimes is not the preferred solution, either. The reason is that such an exemption allows the shifting of the taxation of the basic interest component - within a hybrid structure - to the (low-tax) CFC state. It was concluded earlier that the basic interest component is exactly the element which should be targeted under an anti-avoidance (anti-deferral) legislation. If the legislation provides for an exemption of the basic interest component - even though it is, without any doubt, related to tainted income - the legislation clearly loses its efficiency. In other words, the preference of the principle of capital import neutrality does not support an approach which results in an exclusive taxation of the basic interest component in the CFC state, because it is not the state in which the latter component was produced. For this reason, the existence of a non-optimal scenario requires the current taxation of the basic interest component in the state of the shareholder and not exclusively in the state of the CFC. Overall, it must be concluded that none of the states which follow an entity approach CFC legislation fulfils the aforementioned requirements.

Overall, the difference between the current taxation of income under an entity approach CFC regime and the current taxation of income under a transactional approach CFC regime (including base company rules) is, very general, the fact that the amount of active income - which is not qualified as tainted income under the transactional approach CFC regime - is not attributed to the domestic shareholder under the latter regime.[124] This can be shown by the following picture:

[124] This, of course, is only true if the entity approach leads to a current taxation of income. The latter will usually not be the case if the "active" income prevails within the total amount of income.

Figure 5:



Explanations:

(1) “Income block” divided into active income, base company income and passive income (horizontal) and into the three different income components which are of importance for capital intensive activities (vertical). The vertical separation of the active income / base company income is not required, because no element is included which should be subject to the current taxation of income in the state of the shareholder.
(2) Assumption: passive income = tainted income under the concept of basic interest taxation.
(3) Black-striped area: subject to income allocation under an entity approach CFC taxation only.
(4) Grey area: subject to income allocation under a transactional approach CFC taxation (including taxation under the base company rules) and an entity approach CFC taxation.
(5) Grey-striped area: subject to income allocation under a transactional approach CFC taxation, an entity approach CFC taxation and under the concept of basic interest taxation.
(6) The size of the horizontal and vertical “blocks” is just an assumption.

6.3.4. Conclusions Regarding the Entity Approach

The most important exemption from CFC taxation is certainly the exemption based on the activity of the foreign company. The activity-based exemption typically requires the CFC to carry out mainly an industrial or commercial activity (active business) *and* mainly on the local market, i.e. in the residence country of the CFC. Of course, this excludes most of the inter-company services which are normally directed towards the country of the parent company and the countries where other group companies are established. It goes further than most of the tainted income and base company income rules in the transactional countries. The CFC provisions in the countries which follow an entity approach typically cover the situations which lead to tainted income and base company income under a transactional approach. In addition, the entity approach also encompasses the income related to an active business which is exercised by the CFC as a minor activity. Similar to the base company rules, the entity approach is unconnected to the question of capital intensive or non-capital intensive services. Thus, it is a far-reaching method to cover any inter-company activities which can in theory lead to a domestic tax base erosion. This can be one of the reasons why most of the European countries which apply a CFC legislation follow an entity approach.

If the entity approach, in general, is seen in the light of the principles derived from chapters 2 and 3, it is apparent that the way of separating the activities which result in a CFC taxation from those which provide for an exemption from CFC taxation cannot be in line with these principles. Similar to the transactional approach, the entity approach does not provide for a vertical separation of income. However, in contrast to the transactional approach - which excludes certain types of income from current taxation - the entity approach allocates all of the income derived through the CFC (if the requirements are fulfilled) and this can lead to a taxation of income which, theoretically, should be completely exempt pursuant to the principle of capital import neutrality and which should not even lead to a partial taxation of the basic interest component, e.g. in cases in which the income is produced in the CFC state. In other words, the selection in case of a transactional approach may often result in the taxation of capital intensive activities which - pursuant to the principles of chapters 2 and 3 - may also require a current taxation of the basic interest component whereas the entity approach does not provide for a comparable selection. Overall, however, both approaches are not limited to the taxation of the basic interest component and can thus lead to an over-taxation of income in the residence state of the shareholder which would not be in line with the principles of chapters 2 and 3.

6.4. The Low-Taxation Requirement

6.4.1. General Aspects

All of the European Member States which apply a CFC taxation have - in one way or another - a reference to a certain amount of tax or a certain tax rate.[125] Therefore, the CFC rules typically apply to situations where the income of the foreign company is subject to "low-taxation." What has to be considered "low-taxation" is, of course, quite different from country to country and mainly depends on the domestic income tax burden. For example, in Denmark, a foreign company will be low-taxed in a specific year if the actual tax paid abroad is less than 3/4 of the tax calculated under Danish law.[126] In Estonia, the actual tax burden must be less than 2/3 of the income tax which an Estonian resident individual would have to pay on a similar amount of business income.[127] Pursuant to the Finnish CFC rules, a company is low-taxed if the effective tax rate in the country of the CFC is less than 3/5 of the Finnish tax rate. A different treatment applies for tax treaty countries if the tax rate in the treaty country does not deviate substantially from the Finnish corporate tax rate and the foreign company does not take advantage of any special tax relief in that country.[128] The French rules were applicable when the actual tax in the foreign country was at least 1/3 lower than the French corporate tax that would be assessed on that income. This

[125] See in this respect also: Fédération des Experts Comptables Européens (FEE), FEE Position Paper on Controlled Foreign Company Legislations in the EU, April 2002.

[126] Shelton, New Tax Law for Holding Companies, Tax Planning International Review (June) 2002; Dietz / Buxbom, Denmark: New Less Restrictive CFC Legislation, European Taxation 2002, page 520; Rix, National Report Denmark, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 143. The revised Danish CFC rules - after Cadbury Schweppes - will be outlined in chapter 8.

[127] Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 178. The Estonian CFC rules are limited to resident individuals (Uustalu, page 176).

[128] The Finish National Board of Taxes provided a "black list" of countries with a tax regime for legal entities which substantially deviates from the corporate income tax which legal entities have to pay in Finland. However, it is nevertheless possible that a company resident in one of the listed countries has an effective tax rate which is above the threshold and therefore does not fulfil the requirement of low-taxation. See with respect to the Finnish low-tax requirement Helminen, Finnish Gouvernment Proposes Changes to New CFC Regime, Tax Notes International 1998, page 1431; Juusela, Finland: An Amendment to the CFC Legislation, EC Tax Review 1999, page 88; Grünbaum, Finland: Guidance on CFC Rules and Court Ruling, Tax News Service 1999, page 215; Helminen, Finnish Tax Board Releases CFC Blacklist, Tax Notes International 1999, page 2317.

has now been reduced to an actual foreign tax which is less than 1/2 of the French tax for a similar transaction.[129] In Germany, a foreign company is considered to be subject to low-taxation if the effective tax rate is below 25 percent - which was exactly the German corporate tax rate until the end of the year 2007.[130] Interestingly, the corporate income tax rate was reduced to 15 percent (as of the beginning of the calendar year 2008) but the low-taxation threshold remained untouched. In other words, the low-taxation threshold which is now required under the German CFC regime is higher than the German corporate tax rate of 15 percent. This has to be seen in the context of the German tax system. In contrast to most of the other countries, the trade income tax is quite significant in Germany. The overall statutory tax burden is therefore, after the reduction of the corporate tax rate, about 28-30 percent (corporate tax plus trade income tax). In Italy, the CFC taxation applies to foreign countries which have a significantly lower tax rate, do not exchange information, and other equivalent criteria.[131] In Hungary, the CFC taxation applies to foreign income if the nominal foreign tax rate is less than 2/3 of the comparable taxation under Hungarian law.[132] Under the Portuguese CFC legislation, a low-tax country is one that has a comparable effective tax rate which is equal or less than 3/5 of the Portuguese corporate tax rate or, alternatively, a jurisdiction with a privileged tax regime included in a so-called "black list".[133] In Lithuania, the CFC legislation is applicable if the CFC is subject to a taxation which is less than 3/4 of the standard Lithuanian profit tax rate and if the CFC is established in a state which is not included in the "white list" or which has a "special profit tax or analogous leeway" under the laws of the relevant state.[134] In Spain, a company is considered to be low-taxed pursuant to the Spanish CFC regime if the effective foreign tax rate is less than 3/4 of the domestic tax rate on that income.[135] In the United Kingdom, a foreign company is subject to low-taxation if the actual foreign tax is less than 3/4 of the amount which would have been paid in accordance with the respective domestic rules on that income.[136] The Swedish CFC rules are applicable if the actual foreign tax is less than 55 percent of a comparable Swedish taxation of the CFC income.[137] In the Netherlands, an effective tax rate of 10 percent is required under the "comparable tax test" to avoid the mark-to-market revaluation. The effective tax rate is calculated

[129] The concept of a favourable tax regime is now defined by law. See with respect to the revised French CFC regime Gouthière, Overview of the French CFC Legislation, European Taxation 2008, page 50 et seq.
[130] Section 8 (3) of the German Foreign Tax Act.
[131] The countries and territories with a preferential tax regime are published in a „black list." The list does not contain European Member States, with the exception of Luxembourg in case of the "1929-holding companies."
[132] Liszicza, National Report Hungary, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 308. See with respect to the Hungarian tax reform: IWB Kurznachrichten, Ungarn: Steuerreform 2008 für Körperschaften, Internationale Wirtschafts-Briefe 2007, Fach 1, page 1218.
[133] See de Sousa da Camara / Nuncio, Portugal's 2002 Budget Bill Revises Capital Gains Tax Regime, Tax Analysts Tax Document Service 2001, Doc. 2001-28988.
[134] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 397.
[135] Section 121 (1) letter b of the Spanish Corporate Tax Law.
[136] Medori, United Kingdom to Strengthen CFC Legislation, Tax Planning International Review 2000; Friel, National Report of the United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 871.
[137] Delphi & Co., New CFC legislation introduced in Sweden, December 2003, page 1; Köhlmark / Källquist, New CFC Legislation in Sweden, Bulletin for International Fiscal Documentation 2004, page 227 et seq.; Dahlberg, National Report Sweden, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 589.

according to Dutch standards.[138] From my perspective, the following general approaches can be derived from the country analysis:

- The comparison of the *actual foreign tax paid* by the CFC and the (fictitious) *domestic amount of tax* which would be imposed on the respective income. Among the Member States mentioned above, Denmark, Estonia, France, the United Kingdom and Sweden follow such an approach.[139]

- The comparison of the *effective foreign tax rate* of the CFC and the (fictitious) *domestic tax rate* applied on the respective income. Among the Member States mentioned above, Finland, Germany, Portugal and Spain follow such an approach. It might be argued that Lithuania and the Netherlands also follow such an approach.[140]

- The comparison of the *nominal (or statutory) foreign tax rate* of the CFC and the (fictitious) *domestic tax rate* applied on the respective income. Here, it seems that only Hungary follows such an approach.

- The comparison of tax rates is also, amongst others, an important element of the Italian CFC legislation. However, Italy does not apply - in contrast to the other Member States - a pre-determined fraction or a pre-determined percentage for the comparison.

Overall, the criterion of low-taxation is typically seen in comparison to the (fictitious) domestic tax burden or the (fictitious) domestic tax rate. The threshold is most often defined as a percentage or a fraction of the domestic tax burden or the domestic tax rate which would be applied to a comparable domestic situation, i.e. if the threshold is reached or exceeded, the foreign tax burden or the foreign tax rate is considered to be an acceptable level of taxation or an acceptable tax rate. It is important to recognise that most of the countries determine the income based on their domestic tax rules.[141] In theory, it is possible that the statutory tax rate in the foreign country is comparable to the statutory tax rate of the country of the shareholder, but due to favourable legislation in the CFC country the effective tax rate is “watered down” to a low-tax rate. From this perspective, there is no substantial difference, in my opinion, between an approach which focuses on the actual foreign tax paid and an approach which focuses on the effective foreign tax rate. Both components are finally compared to a (fictitious) taxation or a (fictitious) tax rate in relation to a tax base which is calculated according to domestic standards. However, a comparison of a nominal (or statutory) foreign tax rate with the domestic tax rate is, in my opinion, not a preferable approach. Of course, the comparison may be simpler than in case of a focus on actual taxation or effective tax rates. However, what really matters from an anti-avoidance perspective is not what is stipulated in the respective foreign legislation, but what is the actual result in terms of tax advantages. Here, the link to

[138] The comparable tax test is only relevant if the other requirements are fulfilled, i.e. if the participation qualifies as a portfolio investment company. See with respect to the comparable tax test Articles 13 (10) and 13a (1) of the Dutch Corporate Income Tax Act.
[139] The (fictitious) domestic amount of tax is not (or not necessarily) identical to the amount which is based on the statutory rate of the respective country.
[140] The (fictitious) domestic tax rate is not (or not necessarily) identical to the statutory rate of the respective country.
[141] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 58.

the actual taxes paid by the CFC or the effective tax rate of the CFC seems to be much more efficient. Thus, there are - in my opinion - the following basic features which can be seen as the typical elements with respect to low-taxation in the context of European CFC rules:

a.) A low-taxation threshold in dependence on the domestic income taxation or the domestic tax rate

Each country which applies a CFC taxation has its own low-taxation threshold. This, of course, is fully understandable since it can be assumed that the tax attractiveness of a foreign jurisdiction increases the more the foreign income tax rate deviates from the domestic income tax rate. From an administrative point of view it makes some sense to set a certain threshold in relation to the domestic amount of taxes or the domestic tax rate. Why shall a country bear the compliance costs of a current taxation of income (including a tax credit) in a situation where the foreign income taxation is equal to the domestic taxation or even higher? However, it is obvious that the different income tax rates among the European Member States lead to a variety of different thresholds. Therefore, what is considered to be low-taxation from a German perspective can be seen as acceptable taxation from a Finnish point of view. It is the mere income taxation which is important.[142] Other aspects, for example the fact that the Finnish VAT rate is considerably higher than the German VAT rate, are not relevant for the comparison.

b.) The “bringing in line” of the tax base through the application of domestic tax rules

Apart from the different thresholds it must be taken into consideration that the comparison is based on the adjusted taxable income. Most of the countries apply their own domestic tax rules for the calculation of the tax base and the comparison of the effective taxation in order to determine the effective percentage of taxation. The CFC legislation ignores the actual tax base of the foreign company and the way it is calculated and therefore leads to an equalisation of foreign CFC income with domestic income.

6.4.2. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

It is obvious that the hybrid structures which were outlined in previous chapters are particularly attractive in those cases in which the CFC is taxed at a lower rate than in the state where the recipients of the services are located and in the state of residence of the shareholders, respectively. It is certainly true that states which apply a very low tax rate attract hybrid structures and it is therefore, in principle, understandable that the CFC regimes focus on states where the tax rate is below a certain threshold. Moreover, such an approach also leads to an administrative simplification since the rules are only applied to states where it is likely that an additional tax burden arises on the attributed income. This is not the case if the tax rate in the CFC state is as high as the tax rate in the state which applies the CFC rules or even higher than in the latter state. Since the Member States which apply CFC rules usually follow - in the context of the respective CFC rules - an ordinary tax credit system (and not a full tax credit system), the application to high-tax states

[142] Or any taxation which is comparable to personnel and corporate income tax.

would only result in additional administrative burdens without any additional (positive or negative) effects for the states which apply CFC rules. However, the question arises whether the low-tax requirement, as an important element of CFC regimes, is supported by the economic and equity principles described in previous chapters. Here, it must be kept in mind that the basic conclusion from an economic and equity perspective was that the income should be taxed in the state where it is produced (optimal scenario). The hybrid structures are part of a non-optimal scenario in which the basic interest component is not taxed in the state where it is produced but in an intermediate state. For this reason, there is no basis, from an economic and equity perspective, for an exclusive taxation of the basic interest component in the intermediate state. It was further argued that the non-taxation in the state of the shareholder can support the "clustering effect" in favour of hybrid investments in low-tax states and this might result in serious distortions with respect to the competition among companies and states. For this reason, the residence state of the shareholder should, in general, tax the basic interest component on a current basis. This, at least, is true in a situation in which the income tax rate in the CFC state is lower than in the residence state of the shareholder *and* in the state where the income is produced (if this is a third state). In such a situation, it does not matter whether the deviation from the aforementioned tax rates is a substantial deviation or only a slight deviation. However, in other situations the following aspects have to be taken into account:

- a.) The tax rate in the CFC state is at least as high as in the state where the income is produced (third state), but lower than in the state of residence of the shareholder: in this case, the taxation in the residence state of the shareholder should be limited to the (theoretical) tax rate which would be applied in the state where the income is produced (i.e. in case of an optimal scenario). The current taxation of the basic interest component should therefore not result in an additional tax burden in the state of residence of the shareholder.

- b.) The tax rate in the CFC state is lower than in the state where the income is produced (third state), but at least as high as in the state of residence of the shareholder: in this case, there would be no additional tax in the state of residence of the shareholder, either.

- c.) The tax rate in the CFC state is at least as high as in the state where the income is produced (third state) and at least as high as in the state of residence of the shareholder: in this case, there would be no additional tax in the state of residence of the shareholder, either.

The question is whether the situations described under the letters a-c should result in a current taxation of income at all. This, of course, is also connected to the question whether the state of residence of the shareholder should provide for a full tax credit and therefore also a refund of excess foreign taxes (instead of a mere ordinary tax credit). The latter would be required, as outlined earlier, if one agrees with the "plain" principle of capital export neutrality. This, however, is not the case here. The leading concept should be the principle of capital import neutrality and the (limited) application of the principle of capital export neutrality is just required because of the existence of a non-optimal scenario. However, if the current taxation of income is solely made in order to correct, as much as possible, a situation which is neither acceptable from an economic perspective nor from an equity perspective, this should not result in the necessity of an excess foreign tax credit. For this reason, there seems to be no requirement for an application of the concept of current taxation of the basic interest component if it does not have any impact in the state of residence of the shareholder. It is absolutely clear, though, that this question will be influenced by EU law as well. I will therefore go into further detail in subsequent chapters and will provide an alternative legislation in chapter 9.

However, based on the aspects outlined above it must be concluded that the typical approach of creating a “link” to a low tax rate - which is defined as a fraction or a certain deviation from the domestic tax rate - is not in line with the concept of basic interest taxation. There is no basis from an economic or equity perspective for the application of a system of current taxation of income just in case of a pre-determined fraction or deviation. For example, if a CFC regime stipulates that the rules are only applicable if the tax rate of the CFC is less than 1/2 of the comparable domestic rate, this cannot be the decisive criterion - from an economic and equity perspective - for the question whether the income should be subject to current taxation or not. Why should, in this example, the income which is taxed in the CFC state with 1/3 of the comparable domestic tax rate be subject to current taxation but not the income which is taxed in the CFC state with 2/3 of the comparable domestic tax rate? In my opinion, the answer can only be based on pure anti-avoidance aspects and - perhaps in addition - administrative reasons. However, if the focus of the system of current taxation is on the safeguarding of competitiveness the aforementioned differentiation, based on the pre-determined low tax rate of the CFC (in the example less than 1/2), cannot be considered an efficient and target-oriented approach. In fact, such a concept can only result in further distortions since the separation process is - at least partially - based on a randomly chosen criterion, namely the fraction of (or the deviation from) the comparable domestic tax rate.

6.4.3. Conclusions Regarding the Low-Taxation Requirement

The requirement of low-taxation is a common feature in all European countries with a CFC regime. From the perspective of those countries, the current taxation of CFC income seems to be necessary only in cases where the actual foreign taxes or the effective foreign tax rate are below a certain threshold and the income is therefore considered to be low-taxed. If the CFC income is subject to a taxation which is comparable to the domestic taxation or even higher than the domestic taxation, an immediate attribution of income to the resident shareholder will not take place. Of course, this underlines the anti-avoidance approach of CFC taxation. The low-taxation threshold differs from country to country and mainly depends on the respective domestic income tax rate. Furthermore, the determination of the effective foreign tax rate is in most cases based on the taxable income which is adjusted according to the domestic tax rules. It is therefore the domestic standard which is applied for the determination of the effective foreign tax rate.

It was outlined in chapters 2 and 3 that the current taxation of income should focus on the basic interest component. The only limitation with respect to the tax rate imposed in the state of residence of the shareholder might be the theoretical income tax rate in the state of source. However, there should not be any dependence on the income tax rate in the state of the CFC. For this reason, the link to a certain (low-)tax rate in the existing European CFC regimes, as a requirement for the application of CFC rules, is not supported by the economic and equity principles of chapter 2 and chapter 3, respectively. Of course, such a requirement can be a simplification from an administrative perspective - if the focus is merely on anti-avoidance - but it cannot be derived from the aforementioned principles.

6.5. The Ownership Requirement

6.5.1. Ownership and Similar Rights

Another general requirement for the application of CFC rules is the shareholding in the foreign company. In addition to the ownership in the foreign company, voting rights, dividend rights or similar rights related to the foreign investment are often also referred to as an alternative. This is especially relevant where the percentage of shareholding is relatively low but other rights, e.g. the voting rights, differ from the percentage of shareholding and give the possibility to influence or control the foreign company. It has to be seen as a rule to prevent the circumvention of the CFC taxation and to cover all other significant constellations of having influence. However, the preconditions with respect to the percentage of shareholding, voting rights, dividend rights etc. are fairly different from country to country. For example, pursuant to the Danish rules, the domestic parent company must “control” the foreign company. In this respect, it is sufficient for the Danish parent company to own at least 25 percent of the share capital or to control more than 50 percent of the voting rights at any time during the financial year of the foreign company.[143] In deciding whether a Danish parent company may be deemed to control a subsidiary, shares and voting rights of group companies, individual shareholders and their relatives, and shares held by a fund or trust established by the parent company, group companies, individual shareholders and close relatives are to be taken into account.[144] Based on the Estonian CFC rules, the requirement of control is fulfilled if one or several resident individuals or legal persons own, alone or together with related persons, at least 50 percent of the shares, votes or profit rights in the foreign company. If this is the case, the CFC income will be attributed to resident individuals with a participation of at least 10 percent in the CFC.[145] In France, a resident company – originally – had to hold, directly or indirectly, at least 10 percent of the share capital, the voting rights, or the dividend rights at the end of the year.[146] The percentage has now been increased to a threshold of at least 50 percent. However, the general threshold is to be reduced to 5 percent if 50 percent of the share capital of the foreign company is indirectly held through French companies or foreign companies controlled by the French controlling legal entity.[147] Pursuant to the Finnish CFC rules, the requirement

[143] IBFD, Denmark: Changes Proposed to Taxation Inbound / Outbound Dividends and CFC Taxation, Tax News Service 1999, page 15; IBFD, Denmark: New Regime for Dividend Taxation Enacted, Tax News Service 1999, page 67; Kriegbaum, Denmark Tightens CFC Taxation Once More!, Tax Planning International Review 2001, page 9; IBFD Corporate Tax Summary (Denmark) 2002, page 19; IBFD Corporate Tax in Depth Study (Denmark) 2002, page 154. The revised Danish CFC rules - after Cadbury Schweppes - will be outlined in chapter 8.

[144] See Steenholdt / Josephsen, Denmark: The New Holding Company Regime, European Taxation 1999, page 147 et seq.; Emmeluth, Tax Planning International Forum 2000.

[145] Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 177, 179. The allocation of CFC income is limited to resident individuals (Uustalu, pages 176, 179).

[146] This was applied to shares owned after September 30, 1992. For shares owned before September 30, 1992, a threshold of a least 25 percent existed.

[147] New section 209 B of the French Tax Code; see Ippolito / Pontnau-Faure, France: CFC Rules Reform, Tax Planning International Transfer Pricing, 2005, page 10; Tillmanns, Steueränderungen Frankreich 2004/2005, Internationale Wirtschafts-Briefe, Fach 5, Gruppe 2, page 1417 et seq. (1420); Simmons & Simmons, EU Tax

of control is fulfilled if one or more Finnish residents own at least 50 percent of the share capital of the foreign company or if one or more Finnish residents are entitled to at least 50 percent of the return on capital of the company. The Finnish shareholders are subject to tax on their respective portion of the CFC income if they - and certain related parties - own at least 10 percent of the share capital or are entitled to at least 10 percent of the return on capital of the company.[148] The control situation is evaluated at the end of the accounting period of the foreign company.[149] In Germany, it is required that the resident shareholder owns, directly or indirectly, more than 50 percent of the shares, the voting rights, or dividend rights at the end of the financial year of the CFC.[150] If this is the case, the tainted income of the CFC is to be allocated to all resident shareholders regardless of the size of their shareholding in the CFC.[151] A separate threshold exists for passive income of a capital investment kind: if the income of the CFC includes passive income of a capital investment kind and the shareholding in the CFC is at least 1 percent, the income will be allocated to the resident shareholder, unless the income of a capital investment kind comprises only a minor part of the whole CFC income.[152] The rules even go one step further in case the CFC exclusively or almost exclusively derives gross revenues of a capital investment kind. In such a situation, the relevant income will be attributed to the resident taxpayer even if the shareholding in the CFC is below 1 percent. An exemption exists where the shares in the CFC are quoted on a stock exchange and the shares are traded regularly and considerably.[153] The Italian rules required the CFC to be, directly or indirectly, controlled by an Italian resident at the end of the financial year of the foreign entity. In order to determine the degree of control the Italian CFC rules relied on the definition of control included in the Italian Civil Code.[154] Based on this definition, the foreign company was controlled if the Italian resident had (i) the majority of voting rights that can be exercised in the ordinary general meeting of the foreign company, (ii) sufficient voting rights to influence the decisions taken by the ordinary general meeting, (iii) decisive influence by virtue of contractual agreements with the foreign company. Especially the latter concept of control[155] was rather unusual and led to some uncertainty.[156] Voting rights held by controlled companies, fiduciary companies and of intermediaries were taken into account.[157]

Update, January 2005, page 3; Herbert Smith, New Controlled Foreign Company ("CFC") Rules, French Tax Briefing, January 2005, page 6.

[148] As a consequence the 10 percent ownership requirement cannot be circumvented by splitting the ownership between related parties of the shareholder. The shares have to be added together and if the total shareholding is at least 10 percent, the CFC taxation will be applied; see also Ernst & Young, Country Survey Finland, January 2002.

[149] Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 196, Fn. 23.

[150] Section 7 (1), (2) of the German Foreign Tax Act.

[151] Section 7 (1), (2) of the German Foreign Tax Act.

[152] The income of a capital investment kind must not exceed 10 percent of the gross revenues of the CFC and must not exceed 62.000,00 Euro (section 7 (6) of the German Foreign Tax Act).

[153] Section 7 (6a) of the German Foreign Tax Act.

[154] Article 2359 of the Italian Civil Code; see also Conci / Kessler / Puricelli / Schommer, Die Hinzurechnungsbesteuerung in Italien, Internationales Steuerrecht 2002, page 763 et seq. (764, 765).

[155] *Controllo contrattuale*

[156] See Busetto / Russo, Final Controlled Foreign Companies Legislation Enacted, European Taxation 2001, page 32 et seq.; Favi, National Report Italy, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 354.

[157] Favi, National Report Italy, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 354; see also Giuliani, Italy Introduces CFC legislation, World Tax Adviser (February) 2002; Nanetti, Italy's Controlled Foreign Companies Legislation, IBFD-Bulletin 2000, page 281 et seq.; Gazzo, Italy's CFC Legislation Implemented and

However, the Italian tax reform reduced the required participation substantially. Now, the Italian CFC rules are applicable if the participation in the foreign company is at least 20 percent.[158] In Lithuania, a foreign company is controlled if the resident entity (or individual) together with related entities – directly or indirectly – holds more than 50 percent of the shares or similar rights. The concept of related entities is broader and thus already fulfilled in case of a more than 25 percent participation of one entity in another entity. Based on these rules, there is a "real" controlling requirement (more than 50 percent) for the application of CFC taxation with a broader concept of related entities.[159] The requirement of control must be fulfilled on the last day of the taxable period of the controlled entity.[160] In Portugal, the requirement is fulfilled if a Portuguese resident, directly or indirectly, owns at least 25 percent of the share capital in the foreign company at the end of the financial year of the CFC.[161] Even a participation of 10 percent of the share capital is sufficient if more than 50 percent of the share capital is held by Portuguese residents.[162] In Spain, the CFC rules apply to situations where a Spanish resident company, alone or together with related persons, holds at least 50 percent in the capital, equity, results or voting rights at the end of the fiscal year of the CFC.[163] In Sweden, the CFC rules require a direct or indirect shareholding (or voting rights) of at least 25 percent at the end of the fiscal year of the CFC.[164] In the United Kingdom, control requires the persons to have the power to secure that the foreign company is operated in accordance with their wishes (i) by means of the holding of shares or the possession of voting power in or in relation to the company or any other company, or (ii) by virtue of any powers conferred by the articles of association or other document regulating the company or any other company.[165] In addition, a "joint venture" rule was added to the existing control requirement. The rule applies to situations where (i) there are two persons who, taken together, control the non-resident company; and (ii) one of them is resident in the United Kingdom and has rights giving him control of at least 40 percent of the

Participation Exemption Extended; Bulletin for International Fiscal Documentation 2002, page 77 et seq.; Corabi, The New Italian CFC Regime, Tax Planning International Transfer Pricing, 2001; Conci / Kessler / Puricelli / Schommer, Die Hinzurechnungsbesteuerung in Italien, Internationales Steuerrecht, 2002, page 763 et seq.

[158] Although the revised provisions of the Italian CFC regime had already been included in the tax reform 2004, they became effective as of the tax year 2006 since the publication in the "*Gazetta Ufficiale*" was on October 20, 2006 (see Mayr, Änderungen im italienischen Steuerrecht 2007 (Teil I), Internationale Wirtschafts-Briefe 2007, Fach 5, Gruppe 2, page 559 et seq. (570)).

[159] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 395, 396.

[160] In general, the taxable period in Lithuania is a calendar year. If the taxable period of the controlled entity does not coincide with the calendar year, then for the purposes of the Lithuanian Law on Profit Tax the taxable period of the controlled entity shall be deemed to coincide with the taxable period of the controlling entity (see Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 395).

[161] De Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 780.

[162] Section 57-B, section 60 (1) of the Portuguese Corporate Income Tax Act.

[163] Almudi, National Report Spain, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 563.

[164] See Delphi & Co., New CFC legislation introduced in Sweden, December 2003, page 1; Koehlmark / Kaellqvist, New CFC Legislation in Sweden, Bulletin for International Fiscal Documentation 2004, pages 225-232; Muten, Sweden's CFC Rules Under Change, Tax Notes International 2003, pages 216-217; Dahlberg, National Report Sweden, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 588.

[165] Section 755D of the United Kingdom Corporate Income Tax Act; Ullah, National Report United Kingdom, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 615.

voting power; and (iii) the other person is not resident in the United Kingdom and has rights giving him control of at least 40 percent but not more than 55 percent of the voting power.[166] It is sufficient that the requirement of control is fulfilled at any time during the year.[167] In the Netherlands, the mark-to-market revaluation is only applicable in case of a shareholding of at least 25 percent.[168]

6.5.2. Indirect Ownership

It is not only the direct shareholding in a CFC which is covered by CFC taxation but also the indirect shareholding through, for example, subsidiary companies.[169] Otherwise, the CFC rules could be easily circumvented by the interposition of a foreign subsidiary company which is not subject to CFC taxation and which is located in a country without such legislation.[170] The basic question is how the relevant percentages outlined above have to be applied to indirect shareholdings. This seems to a large extent to be a mathematical question. The countries which require a participation of 50 percent, or more than 50 percent (e.g. Germany), have to reach the threshold - combined or alone - on each of the several tiers between the domestic shareholder(s) and the CFC. For example, a Finish company which owns 50 percent in the shares of a foreign intermediary company which itself owns 50 percent in the CFC fulfils the requirement, even though the mathematical participation in the CFC is only 25 percent.[171] It is decisive that the required percentage is reached on both tiers, irrespective of the mathematical result of ownership on the lowest tier, and gives therefore the possibility to influence the decisions - based on the required Finnish threshold - on all levels of shareholding. The same was basically true for Italy and Germany (as long as it refers to the more than 50 percent shareholding provision). A percentage of more than 50 percent in the CFC was not sufficient if it was not reached on all intermediate levels. For example, if an Italian company held 40 percent in the CFC and indirectly - through a foreign intermediate company - another 30 percent, this did not lead to control in the sense of the Italian CFC legislation if the shareholding in the intermediate company was - for example - only 40 percent. The

[166] Hughes, The U.K.'s Controlled Foreign Companies Legislation: A Very Real Threat, Tax Notes International 2000, page 2528; Taylor, Further Changes to Double Taxation Relief (DTR) and Controlled Foreign Company (CFC) Measures, Tax Planning International Review 2000, page 39; Medori, United Kingdom to Strengthen CFC Legislation, Tax Planning International Review 2000, page 12; Friel, National Report United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 878; Leegaard, United Kingdom: CFC Legislation - Recent Changes to the Acceptable Distribution Policy Exemption, European Taxation 2001, page 294.

[167] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 62.

[168] Article 13a (1), (3) of the Dutch Corporate Income Tax Act; see also Bakker / van de Rijt, Netherlands Corporate Income Tax Reform 2007 - Bill "Working on Profit", Bulletin for International Fiscal Documentation 2006, page 308 et seq. (312).

[169] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 43.

[170] Which was a problem in Sweden where the former CFC legislation was only applicable to direct shareholdings and not to indirect shareholdings in a CFC (see Dahlberg, National Report Sweden, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 587.

[171] 50% x 50%; see the example in Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 196, Fn. 23.

Italian company did not have the control over the CFC, even though the overall mathematical participation in the CFC was 52 percent.[172]

Another approach is the focus on the percentage in the CFC only. This can be particularly relevant for countries which require a lower percentage of participation in the foreign company. For example, the Portuguese CFC rules require a shareholding of at least 25 percent. The indirect control is calculated by multiplying the percentages in a chain of companies. That means the overall percentage in the CFC must be 25 percent or more - irrespective of the percentages in the intermediary companies. Of course, it is clear that from a mathematical perspective the percentage cannot be less than 25 percent in a direct line of intermediate companies, otherwise the participation in the CFC is less than 25 percent, too. However, the question can be of relevance where intermediate sister companies are involved. Here, it seems that only the final result is decisive - and not the intermediate percentages.[173] In other words, a percentage of 24 percent in an intermediate company is sufficient if the final shareholding in the CFC is at least 25 percent (for example in combination with a direct shareholding of the Portuguese resident company in the CFC). This, of course, is a significant deviation from the treatment outlined above with respect to the majority shareholdings and the shareholdings of at least 50 percent.

6.5.3. Constructive Ownership Rules

Another topic which is of importance in the context of direct and indirect shareholding in the CFC is the question of constructive ownership rules. In general, the current taxation of foreign income derived by the CFC has negative consequences for the domestic taxpayer. Since an important element is the percentage of shareholding in the foreign company, it is likely that taxpayers try to avoid that the threshold is reached or exceeded. Therefore, the CFC legislation has to deal with direct and indirect shareholdings (see above) and the shareholdings through related parties. Another theoretical possibility - although certainly less effective - would be to deal with the circumvention of CFC rules in the context of general anti-avoidance provisions. In fact, most of the countries implemented constructive ownership rules within their CFC legislation and therefore try to prevent the circumvention of CFC taxation. The shares, voting rights and similar rights which are held by certain related parties are taken into account for the calculation of the respective threshold and for the answer to the question whether "control" exists or not.[174]

However, the determination of the percentage of shareholding for the question whether the requirement of control is fulfilled or not is to be seen separately from the determination of the percentage of shareholding for the purpose of allocating the respective CFC income to the shareholder. It is obvious that in the first-mentioned

[172] 40% + (30% x 40%) = 52%; see the example in Favi, National Report Italy, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 354. However, the required percentage for the application of the Italian CFC regime was reduced to 20 percent in the foreign company (as of the tax year 2006 - see above for further details).

[173] See the example in: de Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 784, 785.

[174] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 43; Amat / Monasterio, Spain: Controlled Foreign Corporation Legislation, Bulletin for International Fiscal Documentation 1995, page 290; Steenholdt / Josephsen, Denmark: The New Holding Company Regime, European Taxation 1999, page 147 et seq.

situation all types of (constructive) ownership are taken into account and that voting rights (and similar rights) are as important as the shareholding in the company itself. However, if it comes to the allocation of income, the CFC income is allocated to shareholders only. The reason is that voting rights (or similar rights) do not transfer the right to participate in the income of the CFC. It is therefore obvious, in my opinion, that only the participation in the company should result in an income attribution according to CFC rules. As far as I can see there is no European CFC regime which allocates the CFC income to a resident individual or legal entity solely on the basis of voting rights (or similar rights), i.e. without the holding of any shares in the CFC.

6.5.4. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

From an economic perspective, the conclusions regarding a concept which is based on the current taxation of the basic interest component is, in general, not linked to a certain minimum percentage of shareholding or voting rights. The fact that the basic interest component is to be taxed in the residence state of the shareholder is a necessity which is due to the fact that this portion of income is not taxed in the state where it is produced. Hence, it is a measure to safeguard competitiveness within a non-optimal scenario. The current taxation of income in order to come closer to an economically preferred scenario is required irrespective of the degree of influence in the respective legal entity. For this reason, it would be logical, from a mere economic perspective, to apply the concept of current taxation without looking at the percentage of shareholding or voting rights.

On the other hand, a legislation which follows the concept of basic interest taxation should by no means lead to any penalisation of investments. For this reason, a resident investor must have the possibility - also in case of a foreign investment - of gathering the information which is required by the residence state of the shareholder and of fulfilling its (domestic) obligations. The fact that an alternative system should result in a more efficient and target-oriented anti-avoidance (anti-deferral) legislation requires, therefore, that the administrative burden is as low as possible and that the concept appropriately reflects the principle of equity. The minimum threshold for the application of a system of current taxation should therefore be high enough to find a balance between the obligations of the shareholder and the interest of the state of residence of the shareholder to tax part of the income on a current basis. I will deal with this question in some more detail - also with reference to the existing CFC rules - in chapter 9 where the alternative concept will be outlined.

The question of a minimum threshold might also be influenced by the ability-to-pay principle. However, it was concluded in previous chapters that the current taxation of income is - also in case of minority shareholdings - in line with the ability-to-pay principle. This is mainly due to the fact that the tainted income increases the value of the property and therefore improves the ability of the shareholder to pay taxes. This is independent from the question whether the shareholder has direct and immediate access to the “increase in value” or not. However, this is only true under the condition that the negative income is not treated differently from the positive income allocation. A different treatment might seriously distort the concept of current income taxation and, of course, would influence the ability to pay taxes on such income. However, this will be subject to a separate examination.

6.5.5. Conclusions Regarding the Ownership Requirement

The percentage of ownership, voting rights, dividend rights, and other rights related to the foreign company differs considerably from country to country. However, it is important to recognise that the requirement of "control" in the sense of a majority shareholding, i.e. a resident shareholder or a group of related shareholders own *more* than 50 percent of the shares in the foreign company, is in almost all of the European CFC countries not the required criterion. That means, there is either a lower threshold or other - alternative - criteria exist which can trigger the application of the respective CFC rules. This is a significant fact since the majority shareholding is - in a typical situation - the only possibility to decide on a profit distribution of the company against the position of other substantial shareholders (under the assumption that there are no other (substantial) shareholders who support the profit distribution).[175]

Instead, some of the CFC countries require a participation of *at least* 50 percent. However, a shareholding of 50 percent in a company gives only significant influence if the 50 percent test is related to a single shareholder or to a group of shareholders who are somehow related. This is the case in Spain, where the requirement of control is fulfilled if a Spanish resident company, alone or together with related persons, holds at least 50 percent in the capital, equity, results or voting rights. The 50 percent threshold does not make any sense, in my opinion, where it is simply referred to "residents" of the respective country. Pursuant to such a rule, the mere coincidence that a great number of unrelated residents hold 50 percent (or more) in a respective company can trigger a CFC taxation, even though the single shareholder is far away from any substantial shareholding in the foreign company. For example, Germany[176] and Finland[177] have such rules where it is generally referred to residents of the respective country. Similar rules exist in France where the threshold is reduced to only 5 percent if certain requirements are fulfilled.[178]

However, a substantial number of European CFC countries apply a threshold which is *below* 50 percent and does therefore not give sufficient rights to influence a profit distribution or the decisions of the company.[179] The "joint venture" rule in the United Kingdom, for example, triggers the CFC taxation if a shareholding of at least 40 percent exists. In Denmark, Portugal and Sweden a participation of 25 percent is sufficient for the application of the CFC taxation. The same is true for the Netherlands in case of the mark-to-market revaluation.[180] At least, a percentage of 25 percent or more can in some countries be high enough to block certain decisions. But it is certainly not sufficient to actively influence the decisions of the company against the position of other shareholders. Some of the CFC countries apply a threshold of at least 10 percent (e.g. Finland,[181] Portugal[182] and the former CFC rules in France).

[175] At least in a situation where the other shareholder(s) also has / have significant influence on the company.
[176] The requirement refers to *more* than 50 percent of domestic taxpayers (however, separate provisions exist for income of a capital investment kind).
[177] If the requirement of *at least* 50 percent of Finish residents is fulfilled, the allocation of income will only be made to residents with a shareholding of at least 10 percent (related parties are taken into account).
[178] New Article 209 B of the French Tax Code.
[179] Of course, this depends on the respective circumstances.
[180] Article 13a (1), (3) of the Dutch Corporate Income Tax Act.
[181] As a minimum threshold for the allocation of income.
[182] The threshold in Portugal is reduced from 25 percent to 10 percent if more than 50 percent of the share capital is held by Portuguese residents.

Under certain circumstances, e.g. if certain passive income is derived by the foreign company, no threshold at all exists (e.g. in Germany). In the latter case, the income is theoretically allocable to the resident shareholders with a quite insignificant participation and therefore without any influence whatsoever on the foreign company.

A rule which refers to a majority (or at least 50 percent) of resident shareholders - without the requirement of a relationship among those shareholders - can only be understood, in my opinion, in the context of the fear of a national tax base erosion. Why shall the Portuguese (or Finnish / German) CFC legislation be applied to a Portuguese (or Finnish / German) company with a - for example - 10 percent shareholding only because of the fact that a great number of unrelated Portuguese (or Finnish / German) residents hold another 41 percent, whereas a Portuguese (or Finnish / German) shareholder with a participation of 24 percent will not be affected by the CFC taxation if he is the only Portuguese (or Finnish / German) shareholder? Why is a German shareholder with a - for example - 1 percent shareholding currently taxed pursuant to the German CFC taxation just because of the fact that a certain kind of passive income is included in the income of the CFC?[183] Thus, it is apparent that under the existing CFC regimes the legal or factual control is most often not decisive for the question whether the rules are applicable or not. In some cases, the regimes do not even require a “substantial” or “qualified” shareholding, but only an insignificant percentage of participation.

It is also interesting to see that the respective CFC regimes of the Member States most often require the direct or indirect control to exist at the end of the financial year of the foreign company. Exceptions are Denmark and the United Kingdom where it is required that control exists “at any time” in the financial year. Certainly, the focus on the end of the financial year of the CFC simplifies the legislation but opens, at least theoretically, the possibility for transactions in order to circumvent those regimes. However, it can be assumed that transactions which are apparently directed to avoid the application of the CFC regime, e.g. a disposal of shares before the decisive point in time in order to avoid that the threshold is reached or exceeded, followed by a subsequent increase in the participation percentage, will very often be targeted under general anti-avoidance legislation or similar domestic rules.[184] In my opinion, it is certainly advisable to keep the legislation as simple as possible and to avoid complicated rules with respect to the requirement of control. However, as outlined above, the CFC regime itself should restrict, as much as possible, the possibilities of circumventing the legislation. If the CFC regime is not sufficiently supported by general anti-avoidance legislation, or if the respective country does not have such

[183] This can be seen as part of the German FIF provisions which are included in the German Foreign Tax Act.
[184] See - for an overview - OECD, Controlled Foregin Company Legislation, 1996, page 61; Kaufmann, Controlled Foreign Companies (CFC)-Gesetzgebung, Steuer und Wirtschaft International 2001, page 19; Schönfeld, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht, 2005, page 545 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, page 265 et seq.; see with respect to Denmark: Wittendorf, Danish Bill on International Taxation, Intertax 1995, page 213 et seq.; see with respect to Finland and the decision of the Central Board of Finland: Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 196, Fn. 23; see with respect to Italy: Serbini, The New Italian Legislation on Controlled Foreign Companies, Intertax 2001, page 89; see with respect to Portugal: De Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 780, footnote 33; see with respect to Sweden: Sundgren, Controlled Foreign Company (CFC) Legislation in Sweden, Bulletin for International Fiscal Documentation 1990, page 402 et seq.; see with respect to the United Kingdom: Inland Revenue, Controlled Foreign Companies: Guidance on the Provisions of Part XVII Chapter IV ICTA 1988, page 116 et seq.

general anti-avoidance legislation, a “control provision” which requires that the threshold is reached or exceeded at any time in the financial year, as is the case in Denmark and the United Kingdom, might be a more efficient alternative.

From a tax policy point of view - and taking into account the economic and equity principles outlined in chapters 2 and 3 - there is no necessity for a minimum threshold. Instead, if one follows a strict concept of basic interest taxation, as described earlier, the current taxation is equally required for substantial and small shareholdings. However, one has to admit that a basic interest taxation which is applied to minor shareholdings can result in unacceptable administrative burdens which perhaps cannot be handled in an international context - neither by the tax authorities nor by the taxpayer. From a practical perspective, it might therefore be advisable to stipulate a certain minimum percentage of shareholding and a certain minimum percentage of voting rights. As already mentioned above, I will come back to this point in some more detail in chapter 9.

6.6. The Computation and Characterisation of CFC Income

6.6.1. General Aspects

The income computation rules are important in two situations. First, if the income of the foreign company is calculated to determine whether the income is low-taxed and, second, if the income has to be determined for the allocation to the domestic shareholder. In both cases, most of the European CFC countries follow the approach of calculating the foreign income according to domestic rules.[185] This is also true for the calculation according to the “comparable tax test” in the Netherlands.[186] As already outlined earlier, the foreign income is “equated” for the verification whether the requirement of low-taxation is fulfilled or not. This can be of some importance in situations where the foreign tax base is reduced by extraordinary allowances and other measures and where the statutory tax rate therefore deviates from the effective tax rate. However, the “equation” of foreign income to domestic income also takes place in order to determine the amount of income which has to be attributed to the domestic shareholder, i.e. in situations where the requirements of a current taxation based on the CFC rules are fulfilled. At first glance, this comes close to the taxation of a permanent establishment where the credit method is applied. Similar to CFC taxation, the income of the permanent establishment is calculated and taxed based on the rules of *both* countries and the residence state avoids the double taxation by allowing the crediting of the foreign income tax. The significant difference is, of course, the fact that the permanent establishment is legally part of the resident company and not - in contrast to the CFC - a legal entity by itself. However, the comparison of the income allocation with a dividend payment of the foreign company is similarly problematic since the dividend payment is based on the profits derived by the foreign company and those underlying profits are determined in accordance with the law of the foreign country. Furthermore, it must be compared to a complete profit distribution on a yearly basis, which is in practice not always the case. In addition, it must be taken into consideration that the countries which follow a transactional approach do not attribute the complete income of the CFC to the domestic shareholder but only a certain part which is clearly defined. Overall, the calculation of

[185] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 58.
[186] See Articles 13 (10) and 13a (1) of the Dutch Corporate Income Tax Act.

the foreign income based on domestic rules and the subsequent allocation to the domestic shareholder is a procedure which cannot be easily compared to the treatment of the income of a permanent establishment (or partnership) and the treatment of dividends derived from a foreign legal entity.

6.6.2. The Deemed Dividend Approach

The fact that CFC legislation typically accepts the legal status of the foreign company is one of the reasons why the attributed income is sometimes referred to as a kind of dividend income (or deemed dividend). The CFC income is only attributed to the domestic shareholder because of the interest in the foreign company. Without such an interest, nothing would be allocated to the domestic taxpayer (leaving aside the constructive ownership rules).[187] In other words, the CFC taxation is dependent on the fact that a foreign company exists and the domestic taxpayer owns shares in the respective foreign company. In Germany, the attributed income is qualified as income from capital[188] (which is the same for dividends), but without the possibility to apply the half-income principle, and the attributed income is therefore often considered to be a deemed dividend.[189] This is of particular interest since Germany follows a transactional approach and therefore attributes only tainted income to the domestic shareholder. The same is true for the Lithuanian CFC regime which is, according to Bernatonis, to be classified as a system which follows a fictitious distribution concept rather than a system of piercing the corporate veil (look-through).[190] In France, the attributed CFC income is treated under the new system as a deemed dividend paid to the French shareholder, too.[191]

6.6.3. The Piercing the Veil Approach

Another concept is the "piercing the veil" approach, which can also be seen – in my opinion – as a "limited look-through" approach. It is limited because the CFC (i) is nonetheless legally regarded as a separate entity and (ii) is by no means generally considered to be transparent for tax purposes. In case of the countries which follow a transactional approach, only tainted income is attributed to the domestic shareholder and therefore certain active income remains subject to tax *only* in the country of the CFC and *only* on the level of the foreign company – at least as long as it is not actually distributed to the domestic shareholder. The countries which follow an entity approach have to make a classification of the whole activities of the foreign company, and depending on the result of this classification, the CFC income is either completely attributable to the shareholder – at least in the particular year – or it is completely outside of the scope of CFC taxation and therefore – again – *only* subject

[187] I will go into further detail below in the context of double tax conventions.
[188] Article 10 (2) of the German Foreign Income Tax Act; section 20 of the German Income Tax Act.
[189] See, for example, Wöhrle in Wöhrle / Schelle / Gross, Außensteuergesetz, page 104 b et seq., Rust, National Report Germany, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 260; Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 63.
[190] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 400.
[191] New Article 209 B of the French Tax Code; see Tillmanns, Steueränderungen Frankreich 2004/2005, Internationale Wirtschafts-Briefe, Fach 5, Gruppe 2, page 1417 et seq. (1420); Simmons & Simmons, EU Tax Update, January 2005, page 3; Herbert Smith, New Controlled Foreign Company ("CFC") Rules, French Tax Briefing, January 2005, page 6.

to tax in the foreign country. Another issue is the treatment of losses in the context of CFC legislation which in most cases deviates from a "pure" look-through concept and which will be discussed separately. However, it is especially the transactional approach, i.e. the focusing on tainted income, and therefore the separation and "picking out" of income components which is obviously more related to a piercing the veil or limited look through approach than to a "deemed dividend" approach, even though the transactional countries are not completely clear in this respect, either. For example, the Danish CFC rules do not qualify the attributed CFC income - neither as business profits nor as deemed dividends.[192] The same is true In Spain, where the CFC income can be seen, according to Almudi, as an "autonomous category of income."[193]

Among the Member States which follow an entity approach, the predominant concept is the piercing-the-veil approach. This is true, *inter alia*, for Estonia,[194] Italy,[195] Portugal,[196] the United Kingdom,[197] and Sweden.[198] The Finnish approach is not completely clear in this respect.[199] However, it has to be pointed out once more that all of these regimes do not provide for a system of complete transparency (as outlined above). What remains are therefore substantial restrictions, e.g. with respect to the utilisation of negative CFC income. I will come to that aspect below in more detail.

6.6.4. The Re-Valuation Approach

In addition to the deemed dividend and the look-through ("piercing the veil") approach it is also the "revaluation" approach which has to be mentioned in this context. As already described earlier, the Netherlands follows such an approach which results, if all of the requirements are fulfilled, in a yearly mark-to-market revaluation of the participation. Again, the Dutch concept is usually not considered to be a CFC regime, but it comes very close to such a regime. In my opinion, there is no substantial difference to a CFC regime because it may finally result - at least indirectly - in a current taxation of income.

[192] Rix, National Report Denmark, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 160.

[193] Almudi, National Report Spain, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 569.

[194] Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 179, 180.

[195] Favi, National Report Italy, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 360, 361.

[196] De Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 778.

[197] Ullah, National Report United Kingdom, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 611 to 614.

[198] Dahlberg, National Report Sweden, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 832, 833.

[199] Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 200. See in this respect also the Finnish A Oyj Abp Case (outlined in chapter 7).

6.6.5. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The general definition of the domestic concept of income allocation, i.e. whether it is considered a deemed dividend approach, a look-through approach, a yearly re-valuation approach or any other approach is, in my opinion, without relevance from an economic perspective. The decisive point is, however, that these approaches result in an income allocation which does not comply with the principle of capital import neutrality. As I have stated earlier, these approaches also encompass the activity component and the risk component which should clearly not be allocated and taxed on a current basis in the residence state of the shareholder. In this respect, the statements made in the sections dealing with the transactional approach and the entity approach CFC regimes can be referred to.

The current taxation of the total amount of (tainted) income is not in line with the principle of equity, either. Such an approach can place the resident investor who invests in a CFC in a less favourable position than the resident investor who invests in a company without a comparable current taxation of income or who just provides a loan amount to such a company (instead of an equity investment). It was outlined in chapter 3 that in the latter case the investor receives interest income which encompasses all interest components (i.e. including the risk component), but which shall, at the same time, result in the actual and direct risk allocation to the investor, i.e. in case of a realisation of risks it is the domestic tax base which shall be reduced. In case of CFC regimes, however, the total amount of positive income not only encompasses all (theoretical) interest components but also the activity component (either solely related to tainted income or - like in case of an entity approach CFC regime - also the activity component related to non-tainted income). A symmetrical approach would therefore, at least, require the allocation of negative income to be made exactly in the same way and to be treated exactly in the same manner as in case of positive income. This will be examined below. However, even in case of a strict symmetrical approach, the resident investor in a CFC would be confronted with an immediate domestic taxation of the critical elements from an entrepreneurial perspective, namely the activity component and the risk component. This, again, would bring the investor into a less favourable position, especially from the perspective of competitiveness, compared to an investor who is not subject to a current taxation of income.

However, the calculation of the total amount of income of the CFC, including the activity component and the risk component, can be of relevance when it comes to the limitation of the current taxation of the basic interest component. It was outlined earlier that the attribution of income under the concept of basic interest taxation should not be higher than the actual income derived by the CFC. Even though the basic interest component does not contain the risk element, it would not be appropriate to tax a portion of income which is not existent, e.g. in case the risk became reality and the amount of income is lower than the basic interest component. Such an approach would hardly be in line with the ability-to-pay principle and would not be necessary from an anti-avoidance perspective, either. In such a situation, though, there is a requirement to calculate the (total) income of the CFC in order to determine the maximum amount of income attribution. This would be done in addition to the calculation of the basic interest component which, in principle, is also made from the perspective of the state which applies the respective legislation. However, if the CFC state does not follow a very unusual and atypical way of income determination, it would be equally possible, from my perspective, to rely on the actual amount of income determined according to the rules of the CFC state instead of the rules of the residence state of the shareholder. In other words, the only reason for calculating the total amount of income of the CFC should be the determination of the maximum amount of income attribution according to the concept of basic interest taxation, but even this calculation can theoretically be based on the domestic income determination rules of the CFC state. This question will be elaborated further in the context of an alternative system.

6.6.6. Conclusions Regarding the Computation and Characterisation of CFC Income

There are different concepts for the attribution of CFC income to the resident shareholder. The attribution can be seen as a deemed dividend of the CFC (deemed dividend approach) or a direct profit allocation (look-through or piercing the veil approach). Moreover, the Netherlands follow a concept according to which the shares are subject to a yearly revaluation at the market value (revaluation approach). In principle, the aforementioned domestic concepts accept the legal status of the foreign entity. However, none of the concepts is - in my opinion - fully convincing. In fact, the income attribution according to the transactional approach can rather be seen as a system which is solely and directly focused on the separate income elements derived by the CFC from the perspective of the state of residence of the shareholder but - at the same time - completely ignores the income determination of the foreign legal entity. In contrast, the entity approach takes into account all income elements (active and passive) or none of the income elements, depending upon whether the active or passive activities prevail. However, even the complete attribution of income according to the entity approach does not reflect the legal result actually derived by the CFC but only the result from the perspective of the state of residence of the shareholder. In my opinion, it is therefore difficult to combine the transactional and entity approaches with the aforementioned domestic concepts of income attribution. The characterisation of the CFC income is of particular relevance with respect to tax treaties. I will therefore go into more detail later on where the CFC rules are examined in the context of double tax conventions.

The concept which might be derived from chapters 2 and 3 is different because it focuses on the basic interest component of capital. Thus, the dominating factor is the calculation of a certain return on the amount of capital invested and the determination of the actual income - from the perspective of the state of the shareholder - is just required to act as a limitation of the income attribution. In general, the economic and equity aspects do not prevent the state of the shareholder from calculating the amount of attributable income (and the limitation) on the basis of its own tax rules. Moreover, the *domestic* classification of the attributable income is not decisive, in my opinion, as long as the income taxation is limited to the basic interest component.

6.7. Subsequent Dividends and Disposal of Shares

6.7.1. Subsequent Dividends

It should be clear that dividends received by the domestic shareholder from the CFC and the income attributed earlier through the application of the CFC taxation are economically connected. One could even say that the dividend payment and the CFC income have - in an economic sense - an identical source. This is irrespective of the fact whether the attributed income is domestically seen as a deemed dividend or as business income of the shareholder. However, the amount attributable according to CFC rules and the amount which can be legally distributed by the CFC are often not identical. This is mainly due to the following reasons:

- the CFC income is regularly calculated pursuant to the rules of the country of the shareholder and the dividend payment is based on the profits of the CFC which are determined according to the rules of the CFC country. This can lead to temporary differences which disappear in the course of time[200] and to permanent differences;[201]

- the country of the shareholder follows an entity approach and the activities of the CFC change from one year to another together with the classification of the foreign company;

- the country of the shareholder follows a transactional approach and the activities of the CFC contain active and passive income. Here, only part of the CFC income will be attributed to the shareholder whereas a subsequent dividend payment will theoretically contain both, active and passive income elements;

- the percentage of shareholding may change over time (increase or decrease). This can have the effect that the income attribution pursuant to the CFC regime and the income pursuant to the subsequent dividend payments are based on two different percentages of shareholding. It can also be the case that the threshold for the application of the CFC regime is reached in one year but not in another.

Therefore, several general aspects have to be taken into consideration where the CFC actually distributes its profits to the resident shareholder(s).

a.) Avoidance of double taxation caused by a subsequent dividend distribution

It seems to be obvious that an amount of CFC income which was already attributed to the resident shareholder should not be taxed again when the CFC finally distributes its profits. That means, the dividend payments should - in case they are actually taxable in the residence state of the shareholder and not exempt from taxation - be reduced by the amount which was attributed earlier to the shareholder through the application of CFC rules. It can be the case that the overall dividend which is legally payable by the CFC is lower than the CFC income attributed. A typical reason for such a situation can be that the CFC is profitable in earlier years (with the effect of an immediate income attribution) and suffers losses in subsequent

[200] For example, if the CFC country allows extraordinary depreciation on tangible or intangible assets, or if the CFC country allows the assumption of losses of a subsidiary company which is later on reversed. In these cases, the differences will only be temporary.

[201] This can be the case if certain measures applied in the CFC country do not exist in the country of the shareholder and therefore an equalisation over the years cannot take place (e.g. extraordinary allowances). Another possibility is - for example - that the CFC country allows the assumption of losses of a subsidiary company and the losses cannot be reversed in the future.

years which reduces the basis for later dividend payments. Here, the CFC taxation exceeds the dividend distributions. However, the problematic lies especially in the treatment of CFC losses which will be outlined in more detail below. Instead of deducting an amount which is equal to the formerly attributed CFC income from the subsequent dividend it is also possible to determine the amount of tax paid on the attributed CFC income (instead of the CFC income itself) and credit the amount of tax against the income tax imposed on the dividend payment. All of the European countries which apply a CFC taxation have some kind of relief for subsequent dividend payments of the foreign company. Most countries focus on the taxation or non-taxation of the income difference between dividend payment and former income attribution.[202] The United Kingdom applies a tax credit system for the avoidance of double taxation.[203] A time limitation with respect to the relief from double taxation of subsequent dividends will be discussed below together with the treatment of negative income. The reason is that a time limitation is of particular relevance in case of losses.

b.) Withholding taxes on a subsequent dividend distribution

A "timing problem" (or "timing mismatch") exists where the profit distribution of the CFC is subject to a withholding tax. The problem lies in the fact that the attribution of income based on the domestic CFC rules is not subject to withholding tax.[204] If the subsequent distribution is exempt from taxation, no domestic corporate income tax is levied on the dividend income and, therefore, the withholding tax can theoretically not be credited.[205] The problem can be solved - and is sometimes solved - by allowing the crediting of the subsequent withholding tax against the income tax on the former attribution of CFC income, i.e. by a later retroactive adjustment of the original tax notice.[206] In this respect, it is important to consider the position of the OECD to the "timing mismatch" between the taxation in the state of source and the taxation in the state of residence: paragraph 32.8 of the OECD-Commentary on Articles 23 A and 23 B of the OECD-MTC stipulates that the state of residence must provide relief of double taxation regardless of when the tax is levied by the state of source, i.e. in an earlier or later year. This has the consequence, in my opinion, that - in case of CFC taxation - the withholding tax imposed on the dividend payment (usually in later years) should be credited against the income tax imposed on the attributed income in the year in which the latter attribution took place. However, it is also apparent that such a strict and consistent concept of relief is not always provided under domestic legislation.[207]

c.) Non-deductible expenses related to a subsequent dividend distribution

Some of the countries which, in principle, exempt the dividend distribution from taxation in the residence country of the shareholder add back a fixed percentage of

[202] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 65.
[203] Friel, National Report United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 890.
[204] The attribution of CFC income is typically not subject to withholding tax. In fact, the CFC country normally does not even have any information on the attribution of CFC income to its shareholders.
[205] The same is basically true if the amount of tax levied on the CFC income is determined instead of the CFC income itself.
[206] For example in Germany; section 12 (3) of the German Foreign Tax Act.
[207] Paragraph 32.8 of the OECD-Commentary on Articles 23 A and 23 B of the OECD-MTC.

the distribution to the domestic tax base or tax a minor percentage of the distribution in order to cover the non-deductible expenses. The Parent-Subsidiary Directive explicitly allows a fixed amount which may not exceed 5 percent of the profits distributed by the subsidiary.[208] Member States which follow such an approach, i.e. which add back 5 percent of the tax exempt dividend payment to the domestic tax base or, alternatively, which exempt 95 percent of the dividend payment are, for example, Belgium, France, Germany and Italy.[209] However, such a limitation is only of relevance if the country of the shareholder applies the exemption method for the avoidance of double taxation.[210] If the credit method is applied, the dividend distribution is subject to tax in the residence state of the shareholder. As a consequence the expenses related to the foreign investment should be fully tax deductible. In case of CFC taxation, a two-step approach exists: first, the CFC income is attributed to the resident shareholder which leads to a domestic taxation and, second, a subsequent distribution takes place which is - at least partially with respect to the former income attribution - tax exempt. This is true for all of the Member States which apply such a CFC regime – with the exception of the United Kingdom. Under the United Kingdom rules, the tax imposed on the attributed CFC income is deemed to be foreign tax paid by the resident shareholder, which is creditable against the United Kingdom tax on the subsequent dividends received from the CFC.[211] However, since the (original) CFC income attribution is taxable in the residence state of the shareholder, the expenses related to the CFC investment should be fully deductible. There is, in my opinion, no reason for any limitation of the deduction of the expenses which are related to the investment in the CFC. Any exemption of a subsequent dividend payment is just a method of avoiding the double taxation of income in the hands of the shareholder. For example, if CFC income of 100 Euro is attributed in year 01, the subsequent exemption of a 100 Euro dividend payment in year 03 does not lead to a non-taxation of income, but merely ensures that the income is taxed once (and not twice) in the hands of the shareholder. The adding back of 5 Euro to the tax base of the shareholder (or the limitation of the dividend exemption to 95 Euro instead of 100 Euro) results in a taxation of 105 Euro (100 Euro in year 01 and 5 Euro in year 03). In this case, the total amount of income is subject to tax in the residence state of the shareholder and a consistent approach requires the (unlimited) deduction of the expenses which are connected to this income. In other words, there is no room for a standard percentage of non-deductible expenses which solely has the effect of an "over-taxation" of income. At least, this is true where the CFC taxation follows an entity approach. The situation can be different for the transactional-countries. Here, only the tainted income is subject to CFC taxation. Thus, a differentiation is to be made between profit distributions related to tainted income and profit distributions related to active income. In my opinion, any generalisation - like in Germany, France, Italy (see above) - where a fixed percentage of non-deductible expenses is calculated on the complete profit distribution - irrespective of the fact whether all or part of the underlying income was subject to CFC taxation - is not acceptable.

[208] Article 4 (2) of the Council Directive 90/435/EEC, dated July 23, 1990 (Parent-Subsidiary Directive).
[209] See PricewaterhouseCoopers, Corporate Taxes 2004-2005 (2004), Worldwide Summaries, page 65 (Belgium), page 261 (France), page 278 (Germany), page 397 (Italy).
[210] See in this respect also de Hosson, The Parent-Subsidiary Directive, Intertax 1990, page 414 et seq. (432).
[211] Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 65, 66; Friel, National Report United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 890.

6.7.2. Subsequent Disposal of Shares

In general, a capital gain realised by the disposal of shares theoretically includes the retained profits of the CFC. Depending on the activities of the CFC and the results of these activities the capital gain can also include future profit elements which have not yet been taxed according to the CFC taxation. In turn, if the business expectations are negative, the capital gain can theoretically be less than the net book value of the foreign company and therefore reflects only part of the retained profits. Capital gains realised by the disposal of shares and related to profits which were already subject to CFC taxation should be treated similar to dividend income, i.e. the attributed income (or the tax paid on the CFC income) should be taken into account for the determination of a possible taxable gain (or the tax related to the taxable gain). In general, everything outlined above with respect to subsequent dividends is equally relevant for subsequent capital gains. This is in particular true for any fixed percentage of non-deductible expenses calculated on the basis of the capital gains. Similar to dividend payments, the capital gains include retained earnings which have already been taxed in the residence state of the shareholder pursuant to the applicable CFC legislation.[212] Any limitation of deductible business expenses is therefore - in my opinion - not justified. The same is basically true for any time limit, i.e. where the capital gain realised is only exempt from taxation if it contains profit elements which have already been taxed pursuant to the respective CFC legislation within a certain period of time.[213] The fact that more countries provide for a relief from double taxation related to subsequent dividends than for subsequent capital gains is not really understandable.[214] Both events, dividend distributions and capital gains, contain the same profit elements. Moreover, both events are subject to a double taxation of the same underlying income. In my opinion, there cannot be a different treatment in this respect.

Among the countries which are covered by the National Reports to the 2001 IFA Congress, there are only four European Member States which were identified as countries which provide some type of relief for subsequent capital gains: Denmark, Germany, Spain and the United Kingdom.[215] In Denmark, a “taxation-account” ensures that taxable capital gains (and dividends) are reduced by previous CFC income attribution.[216] In Germany, relief is granted for individuals if the time limit of 7 years between CFC income attribution and disposal of shares is not exceeded. In this case, the capital gains will be reduced by the previously attributed CFC income.[217] Capital gains on the sale of shares realised by German corporations are tax exempt, but require the adding back of 5 percent of the capital gains to the domestic tax base.[218] In Spain, the problem of double taxation is solved by an adjustment of the

[212] For example, Germany adds back 5 percent of the tax exempt capital gains realised by the disposal of shares to the domestic tax base; section 8 b (3) of the German Corporate Income Tax Act.
[213] The German 7 year limitation applies to resident individual shareholders; section 3 no. 41 letter b of the German Income Tax Act.
[214] See in this respect Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 65, 66.
[215] Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 66.
[216] Rix, National Report Denmark, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 150, 151.
[217] Section 3 no. 41 letter b of the German Income Tax Act.
[218] Section 8 b (3) of the German Corporate Income Tax Act.

cost base of the shares by the amount of previously taxed CFC income.[219] The United Kingdom CFC regime provides the possibility of deducting the taxes previously imposed on the CFC income from the capital gains on the sale of shares in the CFC.[220] This, of course, can only be seen as a partial relief from double taxation. Thus, among the very few Member States which provide relief for subsequent capital gains, there are still countries, like Germany and the United Kingdom, which either have additional restrictions or which do not provide full relief from double taxation. In other words, an appropriate and unrestricted relief from double taxation caused by subsequent capital gains is rather an exception.

An additional question which can be raised is the question how the losses caused by the subsequent disposal of shares in the CFC should be treated. Here, it may be the case that CFC income is attributed to the shareholder on a yearly basis, but when the shares are sold, the value of the shares is below the acquisition costs. In contrast to a regular dividend payment where an actual value is transferred from the foreign company to the shareholder, there is no such transfer in case of a CFC income attribution. In other words, there is a periodic taxation of income which is not transferred to the shareholder and which is not available anymore at a later point in time - namely at the moment of the disposal of the shares. Below, I will deal with the question of negative income of the CFC and the unsystematic approach of the states which apply CFC rules. In principle, the same aspects are relevant for negative income caused by the disposal of shares: if the positive CFC income is attributed on a current basis, the same should be true for negative income. This, of course, is not only relevant for negative income which is (directly) realised by the CFC itself, but should be equally true for negative income caused by the disposal of shares in the CFC. For example, if the CFC derives interest income in the years 01-09 which is attributed - on a yearly basis - to the shareholder (pursuant to the CFC regime of the residence state of the shareholder), and it turns out in year 10 - just before the disposal of the shares - that the most important debtor will not be able to repay the principal amount of loan, it would be logical, in my opinion, to take into account the respective losses caused by the disposal of the shares (in the same way as the positive interest income related to this investment was taken into account in previous years). Of course, this should equally be true for liquidation losses. However, to my knowledge, none of the Member States which apply CFC rules really provides for a (CFC) *specific* treatment of such losses.[221] That means, some Member States provide relief for capital gains - as outlined above - and some Member States take into account, *in general*, the losses of subsidiary companies (e.g. in Spain[222]) and the losses caused by the disposal of shares or the liquidation of the subsidiary companies (e.g. in the Netherlands). But Member States which provide for a general exemption from capital gains taxation often do not take into account the losses caused by such disposal, either. This is the case, for example, in Germany.[223] Of course, this might be seen as a symmetrical approach for the “normal” cases, but it

[219] Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 66.
[220] Friel, National Report United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 890; Ullah, National Report United Kingdom, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 622.
[221] See the comments with respect to the Dutch mark-to-market revaluation below. However, the latter system is not considered a CFC regime in the narrower sense.
[222] If certain requirements are fulfilled; section 12.4 and 12.5 of the Spanish Corporate Tax Law.
[223] Section 8 b of the German Corporate Income Tax Act.

does not fit together, in my opinion, with the application of CFC rules where (part of) the profits realised through the foreign company are immediately taxed in the hands of the shareholder. In the latter case, there is no complete exemption of the foreign income anymore, and this requires, consistently, that (subsequent) losses are treated differently, too.

According to the Dutch system - which is not a CFC regime in the narrower sense - the mark-to-market revaluation leads to a yearly increase or decrease in the participation which has a direct impact on the tax base of the resident shareholder. In case of a subsequent disposal of the shares the capital gain (or capital loss) realised will be subject to tax in the Netherlands. This is, in principle, a consistent approach. However, one should not overlook the fact that the change in value in a respective year - based on a mark-to-market revaluation - is not necessarily identical to the income derived by the subsidiary company in the respective year. The same will be true in case of a disposal of the shares in the subsidiary. Any mismatch between the regular yearly income of the subsidiary and the increase or decrease in value of the shares (as a taxable event) may finally result in an insufficient (indirect) tax credit. I will come back to this topic later on.

6.7.3. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

It was concluded earlier that a system of current taxation of income should not have any "penalty" effect for the investor, no matter whether the investor derives tainted or non-tainted income. It is therefore apparent that the current taxation of income should not, especially from the perspective of taxpayer equity, result in a disadvantageous treatment of specific types of income. In essence, this is true for a legislation which is based on the horizontal separation of income (like the transactional approach CFC regimes), the non-separation of income (like the entity approach CFC regimes) and the horizontal and vertical separation of income (like the concept of basic interest taxation). From an economic perspective, the current taxation of specific income components should have, as one of the main targets, the effect of safeguarding competitiveness within a non-optimal scenario. However, such a target can only be achieved by a clear and consistent legislation which ensures that the income is not, just by the application of a system of current taxation, subject to double taxation or subject to any other disadvantages, e.g. by the stipulation of time limits for dividends. The double taxation of income may occur if, as described above, the subsequent dividends and the subsequent disposal of shares in the CFC do not, or not sufficiently, take into account the fact that the income from dividends or the income from the disposal of shares have already been subject to income taxation.

Clearly, to the extent that the existing CFC rules do not follow such a clear and consistent concept of avoidance of double taxation, the latter rules cannot provide for a "neutral" system of current income taxation, i.e. a system which has the purpose of correcting, as much as possible, the distortions within a non-optimal scenario but without any inherent "side effects." Essentially, such rules are *pure* anti-avoidance rules which, in my opinion, accept the penalisation of certain investments and accept the deterrent effect of such - to some extent - incomplete legislation. The problem is that by taking into account the total income (including activity component and risk component) the negative effect becomes more important. This, of course, increases the risk for the investor. In my opinion, it should be rather self-evident - not only for a concept of basic interest taxation but also for the existing CFC rules - that the legislation is to be structured in a clear and consistent way which avoids any form of (indirect) penalisation.

6.7.4. Conclusions Regarding Subsequent Dividends and Disposal of Shares

The taxation of actual dividend distributions and the taxation of capital gains on the disposal of shares should always take into account an earlier CFC taxation of the underlying income. Otherwise, the income will be taxed twice in the hands of the resident shareholder. Such a relief can be provided by an adjustment of the tax base or a tax credit, i.e. the former attributable income (or the income tax burden) is deducted from (or credited against) the dividend income or the income from capital gains on the disposal of shares (or the respective tax burden). In principle, there should be no distinction between dividends and capital gains, because a double taxation exists in both situations. A different treatment with respect to capital gains cannot be justified. However, the examination on a country-by-country basis shows that even though the Member States provide for a relief from double taxation in case of dividends, there are only very few Member States which do the same in case of capital gains. Moreover, it has to be noted that the CFC regimes in the Member States obviously do not provide for an appropriate treatment of the combination of CFC income attributions and subsequent losses from the disposal of shares. In my opinion, the treatment of positive and negative income must be symmetrically, and this requires that losses caused by the disposal of shares must be taken into account (in the residence state of the shareholder) in the same way as the previous attribution of positive CFC income. In addition, there should be no time limit for the relief from double taxation caused by subsequent dividends and the subsequent disposal of shares. There is no necessity for such a time limit since the income has already been taxed in the residence state of the shareholder. The expiration of a time limit - before the distribution of the underlying income or the disposal of the shares takes place - would have the consequence of a double taxation of income. Such a limitation could be of particular relevance in case of a tax loss carry forward which will be outlined below. Furthermore, it has to be pointed out that even if the subsequent dividends and capital gains are exempt from taxation, the underlying income was taxed in the residence state of the shareholder. Therefore, any business expenses of the shareholder related to the CFC (entity approach) or the tainted income (transactional approach) should be fully deductible and not be restricted.

In general, the consistent relief from double taxation caused by subsequent dividends and capital gains is necessary according to the principles derived from chapters 2 and 3. The taxation of the basic interest component is an income taxation which is required by economic principles and equity aspects, but which should not have any “penalty effect” for the investor. A consistent relief is, therefore, of utmost importance. However, the methods of providing such relief under a concept which focuses on the taxation of the basic interest component can be different. I will go into more detail of this aspect later on.

6.8. Negative Income and CFC Rules

6.8.1. General Aspects

The treatment of losses in the context of CFC taxation is a quite interesting and important topic since it clearly reveals the unsystematic approach underlying the existing CFC rules. One should generally assume that a system which attributes *positive income* to the domestic shareholder also takes into consideration - in the same way - the *negative income* derived from those activities. This is most often not the case.[224] One should always be aware of the fact that CFC taxation is clearly an anti-avoidance legislation, i.e. it is only applied to certain low-tax countries which are suspected to attract capital from high-tax countries. It is therefore, from the high-tax countries' position, an effective and comfortable method to simply include into the domestic tax base the positive income derived by the CFC but to leave aside the negative income. The attribution of losses - even though systematically necessary - would bear additional "risks" for the high-tax countries, namely a (permanent) reduction of the domestic tax base. The exclusion of negative income in the context of CFC legislation therefore deviates, in principle, from the treatment of a permanent establishment where the credit method is applied and from the treatment of an organic structure with a profit and loss pooling agreement or a fiscal unity.[225] The typical way in dealing with CFC losses is therefore to determine the amount of negative income and to provide the possibility to offset the negative income with positive attributable CFC income in subsequent years, i.e. to allow a tax loss carry forward. An analysis made by the Fédération des Experts Comptables Européens (FEE) in 2002 showed that Finland, Germany, Italy, Portugal, Spain and the United Kingdom do not allow the offsetting of negative income of one CFC with the positive income of another CFC. France was mentioned as an exception, but this exception is only relevant in case of the application of the French (international) consolidation regime.[226] The analysis basically confirms what was already concluded by Arnold / Dibout in the General Report of the IFA 2001 congress: *"(v)ery few countries - Canada, New Zealand and the United States - allow the losses of one CFC to reduce the income of another CFC in certain circumstances, and in all three countries the consolidation relief is limited."*[227]

6.8.1.1. Negative Income in Countries with an Entity Approach

The countries which follow an entity approach do not have to deal with separate income elements but only with the overall positive or negative result which is typically determined on the basis of the respective domestic tax rules. Entity approach countries like France, Finland, Italy and the United Kingdom apply the domestic tax rules for the computation of the attributable amount of CFC income.[228] However,

[224] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 65; FEE Position Paper on Controlled Foreign Company Legislation in the EU, April 2002, page 11.
[225] It has to be noted that PE rules sometimes also exclude certain negative income from the offsetting with domestic income. However, the credit method in case of a PE typically requires the attribution of positive and negative income.
[226] See FEE Position Paper on Controlled Foreign Company Legislation in the EU, April 2002, page 11.
[227] Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 65.
[228] Arnold / Dibout identified only Hungary, Israel, Korea and Portugal – among the countries which were included in the IFA 2001 report – as countries which permit the income calculation according to the foreign tax

such an approach clearly shows - in my opinion - that the countries which apply the CFC rules are not really interested in the result *of the CFC* in a narrower sense but only in the result *of the activities* exercised by the CFC. Irrespective of this fact, I will still use the terminology of the positive and negative income of the CFC in order to avoid misunderstandings. However, one always has to keep in mind that there is a positive or negative result of the CFC based on the trade and tax law of the CFC country and a positive or negative result which is only used for the purpose of the countries which apply their respective CFC rules and which is based on their domestic tax rules. Thus, if the result of the activities of the CFC is positive, it will be completely attributed to the resident shareholder. In contrast, if the result of the activities is negative, entity-approach countries like France, Finland, Italy and the United Kingdom solely provide for the determination of the negative income for the purpose of a subsequent offsetting with positive income.[229] Among the aforementioned countries it seems that only France provides for a (limited) carry back of the negative CFC income.[230] None of these countries allows the domestic tax base to be directly reduced by the negative CFC income.[231] However, if the domestic law provides for a tax loss carry forward which is limited in time, this also applies to the tax loss carry forward of the negative CFC income.[232]

or accounting rules (see Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 58). See also Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation 2004, page 199; Favi, National Report Italy, Ibid., page 361; Ullah, National Report UK, Ibid., page 619; the Portuguese CFC regime provides for a computation according to domestic law (see Borges, National Report Portugal, Ibid., page 537); see also the country overview in Brähler, Controlled Foreign Companies-Rules, 2007, page 265 et seq.

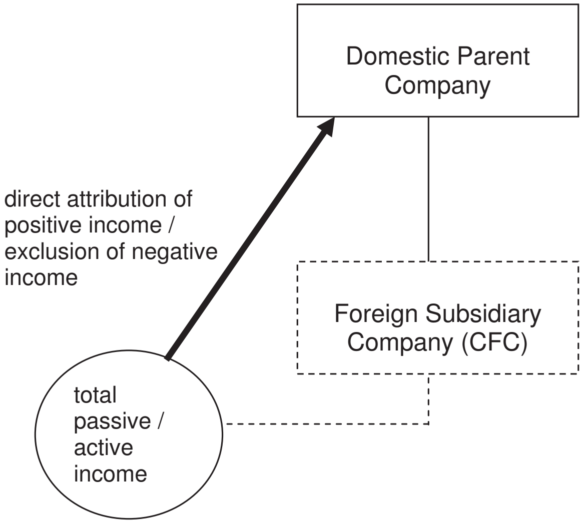
[229] See Brähler, Controlled Foreign Companies-Rules, 2007, page 265 et seq.

[230] See Brähler, Controlled Foreign Companies-Rules, 2007, page 265 et seq. (268); Kabbaj / Raingeard de la Bletière, National Report France, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 233, 234.

[231] See Brähler, Controlled Foreign Companies-Rules, 2007, page 265 et seq.

[232] This is the case, for example, in Italy. See in this respect also Brähler, Controlled Foreign Companies-Rules, 2007, page 265 et seq. (278).

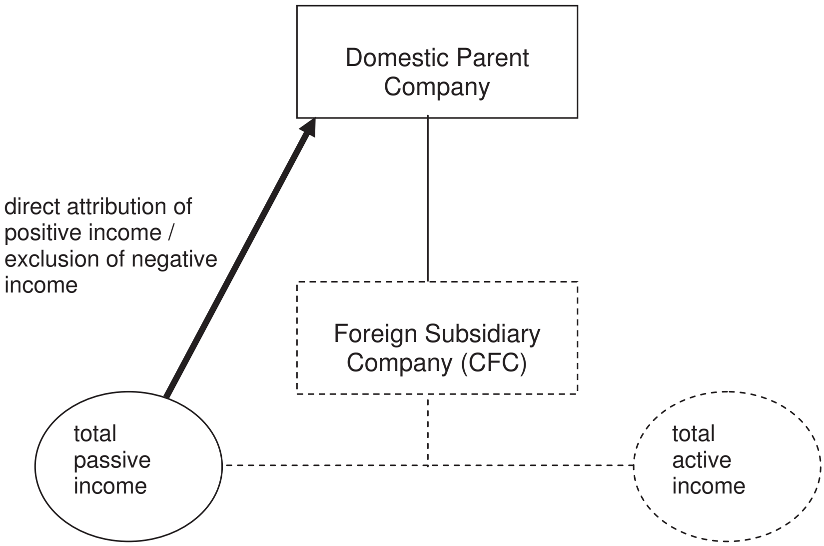
Figure 6:



6.8.1.2. Negative Income in Countries with a Transactional Approach

The treatment of negative income under a transactional approach is different since the CFC legislation only focuses on tainted income and not on the total income derived by the CFC. Whereas Denmark concentrates its CFC taxation on financial income, the German, Spanish and Lithuanian CFC legislation also encompasses other types of tainted income, e.g. base company income. However, due to the fact that the countries which follow a transactional approach CFC regime separate the income derived by the CFC into active and passive income, it is necessary, from a systematic point of view, that these countries have to make the decision whether such a separation is made in the same way for positive and negative income and whether the negative income of one part (passive / active) will be influenced by the positive income of the other part and vice versa. This is not my proposal, but this is just a systematic necessity which has to be identified. In this respect, there is no uniform approach among the transactional countries. For example, the German CFC legislation is solely directed towards the overall result of the tainted income of the CFC, calculated according to the German tax principles, i.e. only the total sum of positive and negative tainted income is relevant. If the total income from passive activities is positive, it will be attributed to the resident shareholder. If it is negative, it can be carried forward (and a limited amount can even be carried back for one year) and offset with positive tainted income. It is not possible to reduce the tax base of the resident shareholder and to offset negative tainted income with positive domestic income. Furthermore, the active (positive or negative) income of the CFC is totally irrelevant and neither influences the amount of attributable income nor the negative income which is to be determined for the tax loss carry forward or the tax loss carry back. This, of course, underlines what was already outlined above: what actually matters is not the CFC itself but only its activities and the income derived from those activities.

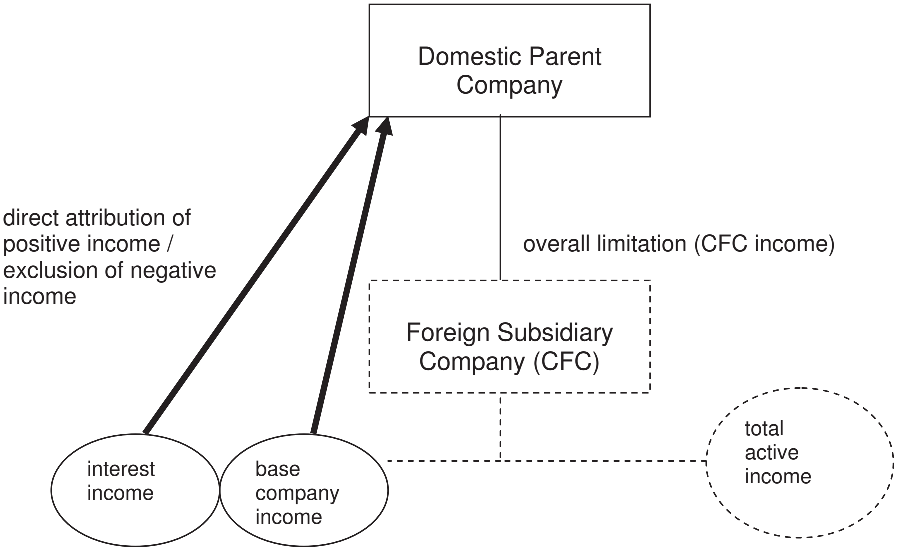
Figure 7:



In contrast to the German CFC taxation, the Spanish rules calculate the net income of each of the different types of tainted income. In general, it is not allowed to offset the negative result of one type of tainted income with the positive result of another type of tainted income (or active income). However, if the total net income of the foreign entity – from active and passive activities – is negative, even if one of the categories of tainted income is positive, the resident shareholder will not be compelled to include any income in the domestic tax base. Therefore, the net income of the CFC is the limitation for the attribution of the positive tainted income.[233] The Spanish rules, even though strictly categorising the income derived by the CFC, take into account the active income for the final decision whether positive tainted income is attributable to the Spanish resident shareholder or not. The approach goes a step further than the German approach which completely ignores the CFC and its active income. The Spanish approach, at least, recognises the CFC and its additional income which can – under certain circumstances – act as a limitation for the attribution of tainted income. The negative tainted income can be carried forward and offset with positive tainted income in subsequent years. The carry forward is limited in time according to the general rules of the Spanish corporate tax law.[234]

[233] Almudi, National Report Spain, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 572.
[234] Almudi, National Report Spain, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 572.

Figure 8:



6.8.2. Specific Aspects

6.8.2.1. The Exclusion and the Limitation of Negative CFC Income

In theory, the limitation of a tax loss carry forward in the residence country of the shareholder is a more general issue which is not directly related to CFC taxation. However, the combination of a general limitation *and* CFC taxation can have a major negative impact on an international group of companies. Even though, in my opinion, the limitation itself is - in general - hardly justifiable,[235] the impact in a purely domestic situation is different to the one where a CFC is involved. If the overall domestic tax base is negative, the resident company does not have to pay income tax. In case the domestic company derives positive income in a subsequent year, the company has to pay income tax out of the positive income (if the tax loss carry forward is utilised or expired). I think this is quite important: the income tax is levied only on positive income - which is in line with the ability-to-pay principle. Clearly, in case the tax loss carry forward is expired, the accumulated net result over the years can still be negative at the moment when the company has to pay income tax, but the income tax burden itself does not lead to a reduction of the net value of the company since it is levied on positive income.[236] The same is basically true where the positive attributable CFC income is brought into play, at least where the increase in value of the participation is theoretically taken into consideration. In a substantial number of countries the attributable CFC income is added to the domestic tax base and

[235] In general, a tax loss carry forward limitation can lead to the outcome that positive income is taxed even though the total positive income does not exceed the total negative income (since the tax loss carry forward is expired). The net value of the activities which are subject to tax is still negative. In my opinion, this is not in line with the ability-to-pay principle.
[236] If the focus is only on the respective tax year.

therefore subject to the regular domestic income taxation.[237] This is the case, for example, in Denmark, Finland, Germany, Spain and the United Kingdom.[238]

The picture is completely different if negative CFC income is involved. It seems to me as if the CFC rules were originally designed for activities which are less risky and therefore typically lead to stable and continuous positive income. This could be a reason, together with the fear of the high tax countries to take into account the negative income of a CFC, why the treatment of CFC losses is most often regulated in the aforementioned unsystematic manner. However, I do not think that the activities carried on by the foreign companies which are subject to CFC taxation are less risky. Especially, if it is assumed that groups are interested in earning more income in low-tax countries but the possibilities of shifting business functions to low-tax countries are limited, the CFC profits can only be maximised if (i) more capital investment is made in the low-tax countries and (ii) higher risks are taken. Since the latter is clearly based on transfer pricing principles,[239] the higher risk - and therefore the change to earn more income - has actually to be taken in the low-tax country. The higher risk also has the consequence that the probability increases that - over a longer period of time - the foreign company will end up with losses (either with an overall loss or with periodic losses). Since the degree of risk and the chance to earn a higher income are clearly connected, the CFC taxation has a fatal effect: in each year in which the CFC income is positive, it will be included in the domestic tax base. In contrast, the negative years are excluded and can only be offset with positive CFC income if it is derived within a certain period of time. The effect can be illustrated by a simplified example: the most important asset of a CFC situated in a low-tax country is a 10-year corporate bond with an increased risk ("junk bond"). In order to cover the risk, the debtor pays a yearly interest of 10 percent to the creditor. As a consequence, the interest income derived from the investment in the corporate bond is attributed to the resident shareholder on a current basis. However, after 10 years of taxing the interest income in the residence country of the shareholder it turns out that the debtor is not able to repay the corporate bond. The loss caused by the investment turns out to be 100 percent. The negative income caused by the default of the debtor will not be taken into account directly in the residence country of the shareholder. A loss carry back in order to offset the negative income with the attributed interest income of the past will not be allowed in most cases, either. In addition, if the loss carry forward is limited in time, there is an increased likelihood that an offsetting with future positive income cannot take place at all (or only to a limited extent). However, this is only one part of the problem. Since the negative income caused by the default of the debtor will not have any impact on the income of the resident shareholder, the latter has to pay income tax on the domestic income as if nothing happened. This is a quite unsatisfactory and unjustified result, especially with respect to the fact that the high interest income - which was necessary to compensate the increased risk - was taken into account and taxed in the residence country of the shareholder year by year. In this case, the risk component (risk premium) is subject to current taxation in the state of the shareholder, but the latter

[237] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 63.
[238] Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 63. In the General Report Germany was mentioned as one of the exceptions to this approach. However, the legislation changed afterwards (section 10 (2) of the German Foreign Income Tax Act); for a country overview see also Brähler, Controlled Foreign Companies-Rules, 2007, page 265 et seq.
[239] Such as the arm's length principle.

state does not provide sufficient relief when the risk becomes reality, i.e. in case of the default of the debtor. This is an unsystematic and asymmetrical treatment of income which neither supports taxpayer equity nor the safeguarding of competitiveness. Moreover, such a situation is, in my opinion, clearly not in line with the ability-to-pay principle. I will come back to these aspects below in more detail.

A system which follows a yearly mark-to-market revaluation of the shares in the subsidiary company and which consistently takes into account positive and negative developments, as in the case of the Netherlands, considers, at least to a certain extent, the negative income derived by the subsidiary company. However, as already outlined earlier, the change in market value does not necessarily correspond to the (positive or negative) income derived by the subsidiary in the respective year. Nonetheless, it must be concluded that, in this regard, the Dutch legislation follows a symmetrical system of income taxation.

6.8.2.2. Negative Domestic Income of the Shareholder and CFC Income

The situation where the resident shareholder has a domestic tax loss carry forward available in combination with the attribution of positive CFC income is equally unsatisfactory. At least, the problem is, in principle, comparable to any other situation where the credit method is applied to foreign income. Here, the problem lies in the fact that the income derived through the interposition of the foreign company is taxed twice: first, in the state of residence of the foreign company (in the hands of the foreign company) and, second, in the state of residence of the shareholder (in the hands of the shareholder). Thus, for the countries which apply CFC rules and which strictly follow the concept of an ordinary tax credit system for taxes paid in the CFC country, as is the case in most of the Member States with CFC rules,[240] there is no possibility for an appropriate relief from economic double taxation. In those cases, *partial* relief from double taxation can be achieved if the country which applies the CFC taxation provides for a deduction of the taxes paid from the domestic tax base, i.e. a corresponding reduction of the attributable income. In Germany, for example, the shareholder can choose between an ordinary tax credit and a deduction from the tax base of the taxes paid in the CFC country - and can therefore react to the different circumstances.[241] I will go into more detail of the relief provisions below. It is apparent, however, that the effect of a deduction of the foreign taxes is by no means comparable to the effect of a tax credit. Still, the positive CFC income attribution reduces the domestic losses (or the tax loss carry forward) of the resident shareholder and therefore also the possibility for the offsetting with positive (domestic) income in the future. Even though this is nothing special since it is the regular procedure where the credit method is the underlying method of avoiding double taxation, it has to be seen as an additional serious disadvantage in combination with the treatment of CFC losses as outlined above. Furthermore, it has to be noted that there can be a major difference to the situation where the domestic shareholder holds a substantial interest in a legal entity and where the CFC rules are not applicable. Here, the shareholder can - depending on the percentage of shareholding and voting rights - influence the actual dividend payment, with the effect

[240] I will go into more detail of the concept of an ordinary tax credit system in the context of CFC rules in section 6.9. See in this respect also Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 64; FEE Position Paper on Controlled Foreign Company Legislation in the EU, April 2002, pages 11, 12.
[241] Section 12 (1) of the German Foreign Income Tax Act.

that the distribution is made in a year which allows the full crediting of the foreign taxes. In other words, a majority shareholding without CFC taxation provides much more flexibility with respect to an efficient distribution policy than a majority shareholding with CFC taxation. This, again, is of particular relevance in case of tax credit limitations (e.g. in case of tax losses).

6.8.2.3. Time Limit for Subsequent Dividends

As already outlined earlier, there are several ways in dealing with subsequent dividend payments in order to avoid that the underlying income is taxed twice, as attributable CFC income *and* as taxable dividends. However, countries like Finland and Germany have a time limit for the relief from double taxation. Even though both countries generally exempt dividends in a parent-subsidiary relationship, the time limit is of relevance, for example, in case of individual shareholders and partnerships.[242] In Finland, an actual dividend distribution is regarded as taxable income of the Finnish shareholder only to the extent that the amount received exceeds the amount included in the taxable income of the Finnish taxpayer in the same or the previous five tax years.[243] The same is true in Germany, with the exception that the CFC income has to be included in the taxable income of the German taxpayer in the same or the previous seven years.[244] It is obvious that the time limit can be of particular relevance in case of negative CFC income and negative income of the resident shareholder. In order to avoid the double taxation of CFC income and dividend income the CFC is *forced* to distribute the profits within the respective time limit. Apart from the question whether the resident shareholder has any influence on the profit distribution, there are other serious aspects which are relevant in case of negative income:

- The CFC can be in a position which does not allow any profit distribution during the relevant period. For example, a - currently attributable - profit was derived in year 01 which was followed by a loss in a subsequent year which cancelled out the profit of year 01. The CFC can legally be in a position which disallows any profit distribution. Even though a later attributable CFC income can be offset with the tax loss carry forward of the negative CFC income, the original profit of year 01 cannot be distributed tax exempt if the time limit has expired.

- The resident shareholder with a tax loss carry forward is subject to partial double taxation through the attribution of positive CFC income during that period (since the corporate income tax of the CFC can only be deducted from the domestic tax base but not be credited against domestic income tax). In case the subsequent “mandatory” profit distribution is subject to withholding tax, the shareholder will also suffer a partial double taxation related to the withholding tax. The shareholder can be forced to accept the withholding tax

[242] With an individual as a partner in the partnership.
[243] Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 202; IBFD Corporate Tax Summary Finland, 2002, page 16.
[244] Section 3 no. 41 letter a of the German Income Tax Act.

disadvantage in order to avoid more serious disadvantages caused by the expiration of the time limit.[245]

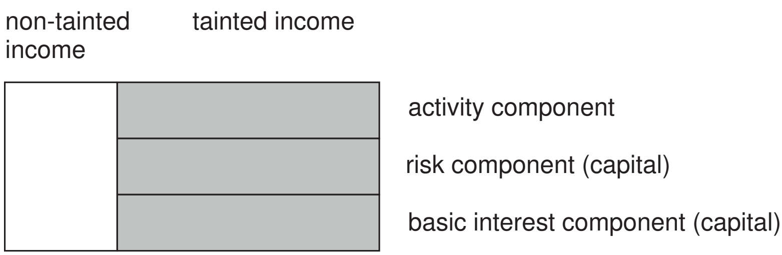
6.8.2.4. Time Limit for Subsequent Capital Gains on the Sale of Shares

What was outlined above with respect to the double taxation of dividends is, in principle, equally true for the taxation of capital gains on the disposal of shares. It will therefore not be described separately. In fact, any time limit for subsequent losses caused by the disposal of shares in the CFC would also be unacceptable. However, since the Member States which apply CFC rules do not provide for any specific treatment of such losses anyway, there is no reason to deal with this question in this context. Again, the exception from the unfavourable and unsystematic treatment in case of losses is the Dutch mark-to-market revaluation which was already outlined earlier and which is not to be considered a CFC regime in the narrower sense.

6.8.3. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The combination of CFC taxation and negative income - on the level of the CFC and / or the level of the shareholder - can clearly be seen, in my opinion, as one of the most serious risks for a double taxation of income. In this respect, it might be interesting to have a look at the impact on the respective income components included in the tainted income.

Figure 9:



Explanations:

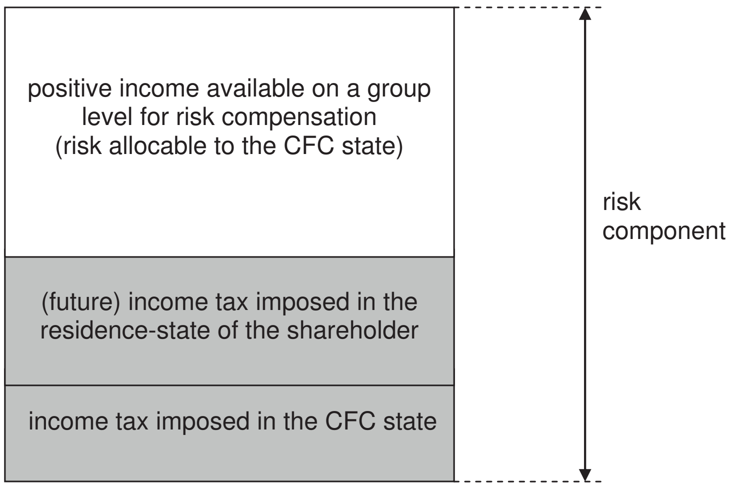
(1) “Income block” divided into tainted and non-tainted income (horizontal) and the three different income components which are of importance for capital intensive activities (vertical). The vertical separation of the non-tainted income is not required, because no element is included which should be subject to the current taxation of income in the state of the shareholder.
(2) The activity component encompasses the income which is related to the carrying out of the respective functions and risks (but not the risk which is related to the capital investment).
(3) The size of the three income components is just an assumption.

The components which are of particular interest are the risk component, the activity component and the basic interest component. A further subdivision into the different risk elements - as shown in chapter 2 - is not required. As an example, it shall be assumed that positive CFC income is attributed to the resident shareholder, but the

[245] Without a profit distribution in the relevant period the tax loss carry forward will be reduced twice: by the attributable CFC income and by the profit distribution which is outside of the time limit.

domestic tax base of the resident shareholder - including the attributed positive CFC income - is negative. In this case, no income tax is imposed in the state of residence which allows the shareholder to credit the income tax of the CFC in the respective year. It shall be assumed further that no roll-over is available which provides the possibility for the shareholder of crediting the amount of CFC tax in a subsequent year, but only allows him to offset the positive CFC income with the negative domestic income. With respect to the risk component the picture looks as follows:

Figure 10:



The income tax imposed in the CFC state plus the income tax which will be imposed in the residence state of the shareholder (in a subsequent year when the tax base becomes positive) will lead to a reduction of the amount of income (on a group level) which is theoretically required to offset the risks involved in the respective investment. If the CFC regime provides for an alternative deduction of the income tax imposed in the CFC state from the income tax base in the state of the shareholder, the deduction only reduces the effect of double taxation but does not eliminate the latter effect. If there is not even a possibility for an alternative deduction, there is no elimination of double taxation at all.[246]

The problem is, *inter alia*, that the negative income which is caused by the risk, i.e. in case the risk is realised, does not result in a similar reduction of the income tax base. In other words, the asymmetrical approach of CFC taxation takes away a portion of positive income which is not "given back" in case of negative income. Again, this is not a side effect, but an effect which is caused by the general system of treating positive CFC income different from negative CFC income. Despite the fact that the risk component is not subject to taxation in the state where the income is produced (at least not subject to a regular income taxation), it is necessary, in the context of

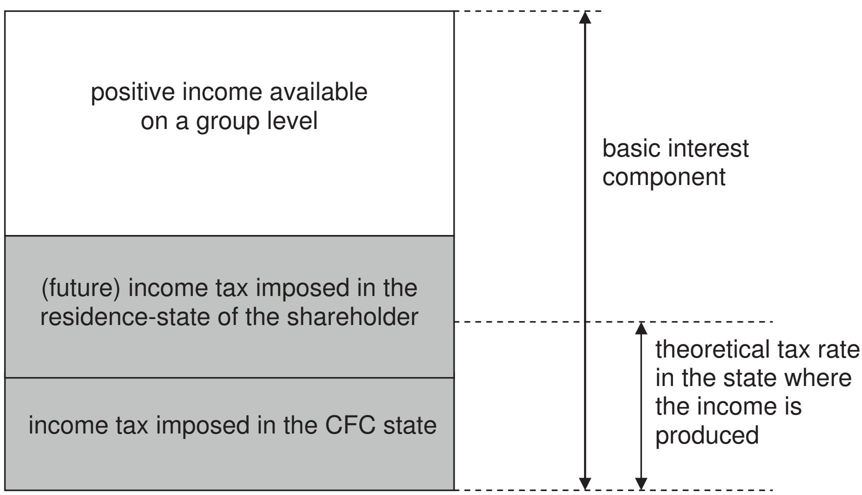
[246] See section 6.9. for further details.

such an non-optimal scenario, to provide for a symmetrical relief in case of positive and negative income. Essentially, this results in a distortion of the necessary balance between the risk component (risk premium) and the theoretical risk. Such an approach results in an unfavourable treatment of the investor in the CFC (related to the risk component) and therefore does not support taxpayer equity. Moreover, the general non-existence of the "risk balance" by no means safeguards competitiveness within a non-optimal scenario. In addition, it can hardly be argued that a concept which taxes positive income on a current basis but does not, at the same time, provide for sufficient relief in case of negative income is in line with the ability-to-pay principle. This, of course, is particularly obvious in case of the risk component where an inseparable link exists between the risk premium and the (subsequent) actual risk. In such a case, the existence of negative income can result in a systematic over-taxation of the total amount of (accumulated) positive and negative income. In fact, it may result in a situation where the total amount of accumulated income (over a period of more than one year) is zero or negative, but a substantial amount of taxes was imposed on that income. Such an example was outlined above (the holding of a corporate bond followed by the default of the debtor). The argument that the taxpayer is in a position to pay the taxes at the point in time when the positive income is allocated is by no means satisfactory. In my opinion, one cannot just focus on one single year but must concentrate on a longer period of time. This, again, is particularly obvious for the risk premium. Thus, if the risk becomes reality, there must be an appropriate and consistent relief in order to avoid the taxation of income which is not existent (any more).

In principle, similar aspects are relevant for the activity component included in the tainted income (and, of course, also in the non-tainted income). In this case, however, the income taxation in the CFC state can be seen as the optimal economic result, because this part of the income is produced in the latter state. Here, the strict application of the principle of capital import neutrality requires the exclusive taxation in the CFC state. The asymmetrical taxation of positive and negative income would essentially have a similar effect as in case of the risk component, i.e. the (additional current) taxation in the state of residence would take away positive income which is required to operate successfully in the local market and to compete with local and international companies in the respective market. In other words, the CFC taxation of the activity component cannot be justified, as already outlined above, from an economic and equity perspective.

The situation with respect to the basic interest component is a bit different. Here, there is neither the carrying out of functions nor the taking over of risks which "matches" the respective income in the state of the CFC. In fact, the functions are carried out and the risks are taken in the state where the underlying income is produced (which is not the CFC state). It was concluded earlier that the basic interest component should be subject to current taxation in the residence state of the shareholder, but the taxation should, at least theoretically, be limited to the tax rate which would be imposed in the state where the income is produced. However, this does not mean that the avoidance of double taxation is of less importance. The principles outlined in chapter 2 and chapter 3 require the income to be currently taxed in the residence state of the shareholder at a rate which would be applicable on such income in comparable (domestic) situations (if the rate is not higher than in the state where the income is produced). For this reason, any asymmetrical treatment of positive and negative income which involves the risk of a double taxation of income is unacceptable with respect to the basic interest component, too. At the end, any double taxation is a clear obstacle for any neutral concept of taxation and will neither support competitiveness nor taxpayer equity.

Figure 11:



The current taxation of the basic interest component which exceeds the theoretical taxation in the state where the income is produced restricts the possibility of the group of competing with other (local or international) companies in the latter state. However, the fact that the basic interest component is not connected to a corresponding risk in the CFC state (i.e. which might have a direct impact on the taxable income in the CFC state) is a substantial difference to the risk component. The same is true for the activity component: the functions and risks related to the activity component included in the tainted income are clearly connected to the CFC state. In other words, and as already outlined above, the current taxation of the basic interest component is required to safeguard competitiveness and to support taxpayer equity, but the system must not lead to a double taxation of income.

The fact that the existing CFC regimes often provide for such an unsystematic and asymmetrical treatment of positive and negative income - which basically encompasses all three income components - can by no means be in line with the aforementioned principles.

6.8.4. Conclusions Regarding Negative Income and CFC Rules

For me, the treatment of losses in the context of CFC legislation is inconsistent, unsystematic and goes much further than is really necessary from an anti-avoidance point of view. It is too simple, in my opinion, to allocate positive CFC income to the resident shareholder on a current basis without taking into account the domestic situation and to accept - at least partially - a double taxation of income, while on the other hand the negative CFC income is completely separated and excluded. In fact, the negative CFC income in most cases does not have any influence on the domestic tax base, even if it exceeds the positive domestic income. In addition, some countries apply tax loss carry forward limitations on the CFC income and time limitations for subsequent dividend distributions and capital gains. This, of course, can negatively influence the whole situation, too. Overall, it must be concluded - in my opinion - that such an unsystematic treatment is not justifiable from a tax policy point of view, e.g. with respect to the ability-to-pay principle.

Furthermore, what was already outlined with respect to the relief from double taxation in case of subsequent dividends and capital gains is equally relevant in the context of negative income (either of the shareholder or the CFC): the principles derived from chapters 2 and 3 do not allow the penalisation of the investor. The current attribution of income under a CFC regime or under an alternative regime which solely focuses on the taxation of the basic interest component must not result in a treatment which is worse than in a purely domestic situation and which is worse than in case of regular dividends and capital gains. The leading principle should be the non-discriminative taxation of the attributed income. Of course, the current taxation of certain income components will always be different from the situation in which the shareholder can decide on the point in time of the distribution of income (or the sale of shares), but the first-mentioned situation must not result in a systematic over-taxation of income in case of negative income.

6.9. Relief for Foreign Taxes

6.9.1. Taxes Imposed by the CFC Country

The application of CFC rules by the residence state of the shareholder can lead to an economic double taxation of income. This is due to the fact that the underlying income is taxed in the residence state of the foreign company *and* the residence state of the shareholder. Double taxation is therefore in most countries avoided by allowing a tax credit of the foreign income tax paid by the CFC against the domestic tax burden calculated on the attributed income.[247] An ordinary tax credit for the taxes imposed on the income in the CFC country is granted in Denmark,[248] Estonia,[249] Finland,[250] France,[251] Germany,[252] Italy,[253] Lithuania,[254] Portugal,[255] Spain,[256]

[247] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 64; FEE Position Paper on Controlled Foreign Company Legislation in the EU, April 2002, pages 11, 12.

[248] Rix, National Report Denmark, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 149, 150.

[249] Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 180.

[250] Juusela, National Report Finland, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 484.

[251] See with respect to the revised French regime: Goulard / Jolly, French Lawmakers Revisit CFC Rules, Tax Notes International 2005, page 219 et seq. (221).

[252] Schumacher, National Report Germany, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 535; section 12 (1) of the German Foreign Income Tax Act.

[253] Valente / Magenta, Italy: New CFC Legislation, Intertax 2001, page 55; Busetto / Russo, Italy: Final Controlled Foreign Companies Legislation Enacted, European Taxation 2001, page 36; Giuliano, National Report Italy, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 629, 630.

Sweden[257] and the United Kingdom.[258] The Dutch regime of a mark-to-market revaluation provides for a notional indirect tax credit of 5 percent (in case the actual tax credit is lower).[259] In contrast thereto, Hungary does not provide for any form of indirect tax credit for the relief from double taxation.[260] In Spain, a differentiation is made between a CFC situated in a listed tax haven and a CFC which is situated in a non-listed low-tax country. In the first-mentioned case of a listed tax haven, there is no possibility for a tax credit in order to discourage the use of such territories or countries.[261] Germany, for example, provides the possibility for an *alternative* deduction of the foreign taxes instead of a tax credit. However, it seems that the provision of a choice between tax credit and tax deduction is an exceptional approach. At least, I did not find any other European CFC legislation which provides for such an alternative deduction.

A deduction (instead of a tax credit) might be particularly relevant where the resident shareholder suffers losses or has an existing tax loss carry forward available and is therefore not in a position to credit the foreign tax against the domestic income tax. In this case, however, a double taxation can only partially be avoided. Overall, the system is comparable, from a technical perspective, to a credit system in case of a permanent establishment, i.e. the foreign income is determined and taxed pursuant to the domestic tax rules, and the foreign income tax is credited against the domestic income tax levied on the respective income.

6.9.2. Taxes Imposed by Third Countries

The income derived by the foreign company can be subject to tax in a third country, e.g. by levying withholding taxes on interest income, royalty income or dividend income. Furthermore, the foreign company can create a permanent establishment in a third country by carrying on its activities, e.g. base company activities, with the effect that the income allocable to the permanent establishment is taxed in the third country. It is quite obvious that the tax credit for taxes paid in third countries makes

---

[254] Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 400, 401.
[255] De Sousa da Camara / Ayala, Portugal: CFC Taxation, European Taxation 1996, page 24; de Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 783.
[256] Raventós, Spain: CFC Provisions Introduced, European Taxation 1995, page 166 et seq.; Casero, The Foreign Base Company in the Spanish Tax Law, Intertax 1995, page 586 et seq.; Prats, National Report Spain, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 815, 816.
[257] See Brokelind, Group Taxation and CFC Rules in Swedish Tax Cases, Tax Notes International 2005, page 237 et seq. (240, 241). It must be noted that the Swedish system did not provide, originally, for a tax credit in CFC cases: see in this respect Dahlberg, National Report Sweden, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 593; Köhlmark / Källquist, New CFC Legislation in Sweden, Bulletin for International Fiscal Documentation 2004, page 230.
[258] Friel, National Report United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 889, 890.
[259] Article 23c of the Dutch Corporate Income Tax Act; see also Bakker / van de Rijt, Netherlands Corporate Income Tax Reform 2007 - Bill "Working on Profit", Bulletin for International Fiscal Documentation 2006, page 308 et seq. (312).
[260] Deák, National Report Hungary, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 557.
[261] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 65.

the legislation even more complex. In Spain, for example, the CFC regime clearly provides the possibility for the crediting of income taxes paid by the CFC in third countries - including withholding taxes.[262] The same is true, for example, in Denmark,[263] Finland,[264] Germany,[265] Italy,[266] Sweden,[267] and in the United Kingdom.[268]

a.) Withholding taxes

It should be clear that the withholding taxes deducted from the income derived by the CFC should be taken into account in one way or another. If the withholding taxes, e.g. on interest or royalty income, cannot be credited in the residence country of the CFC, it should - in effect - be credited against the income tax calculated on the attributed CFC income of the resident shareholder. There can be several reasons for such a non-crediting of withholding taxes. For example, the taxable income of the CFC is negative or too low for a full crediting. This can be due to the fact that the CFC has additional business expenses which are not accepted according to the income calculation rules of the residence country of the shareholder, or the CFC derives negative income from active business which cannot be taken into account pursuant to the domestic CFC legislation. This is especially relevant for countries which follow a transactional approach. Or, very simply, the tax rate in the CFC country is lower than the withholding taxes applicable on the respective income. In all these cases it is required, in my opinion, to allow a tax credit in the country which applies the CFC taxation and not simply provide for a deduction of the withholding taxes from the taxable income.[269] Otherwise, there will be a partial double taxation of CFC income. Of course, if the income derived by the CFC is outside of the scope of the domestic CFC legislation, e.g. dividend income,[270] there is no space and no necessity for a crediting in the residence country of the shareholder. From a technical point of view, the most logical way is certainly to credit the amount of tax actually payable in the countries, i.e. the corporate income tax in the CFC country (reduced by the withholding taxes which are actually creditable in the CFC country) plus the complete amount of withholding taxes imposed by third countries on the respective income elements. The situation can become more complex if the CFC state provides for a roll-over of the withholding tax (e.g. from year 01 to year 02). In my opinion, the CFC regime of the residence state of the shareholder should, in such a situation, allow the crediting of the withholding tax against the corporate income tax imposed on the attributed CFC income in year 01 (if there is a positive attributable income in

[262] Raventós, Spain: CFC Provisions Introduced, European Taxation 1995, page 166 et seq.; Casero, The Foreign Base Company in the Spanish Tax Law, Intertax 1995, page 586 et seq.; Prats, National Report Spain, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 815, 816; Almudi, National Report Spain, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, pages 569, 570.
[263] Art. 32 of the Danish Corporation Tax Act.
[264] Art. 6 of the Finnish CFC Act.
[265] Section 12 (1) and section 10 (1) of the German Foreign Income Tax Act.
[266] Art. 167 of the Consolidated Act on Income Taxes (T.U.I.R.).
[267] Sections 18-22 AvrL.
[268] Ullah, National Report United Kingdom, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 621; see in this respect also Friel, National Report United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 890.
[269] As a kind of business expenses.
[270] As already outlined earlier, dividend income is not always and under all circumstances subject to CFC taxation.

year 01). However, in order to avoid that the withholding tax is taken into account twice, the effect of tax credit in the residence state of the CFC, e.g. in year 02, must be eliminated. Moreover, the situation may exist, as outlined above, that there is no possibility for a tax credit in the residence state of the shareholder (e.g. due to tax losses). In this case, it is unsatisfactory, in the same way as for the corporate income tax imposed in the CFC state, that the withholding tax is merely deducted from the tax base. This, again, will only lead to a partial elimination of double taxation of income. Thus, if the state which applies the CFC regime allows for a (general) roll-over of non- or partially credited withholding taxes of the shareholder, the system should also encompass the treatment of creditable taxes in the context of the application of the CFC regime. A roll-over is provided, for example, by the Portuguese CFC regime.[271] Apparently, an alternative anti-deferral regime which focuses on the basic interest component instead of the complete amount of (interest) income must provide for a relief-system which, of course, also takes into account the withholding taxation outside of the CFC country in order to achieve the aim of complete neutrality. I will go into more detail of that aspect later on.

b.) Income taxes levied in the country of a permanent establishment

Similar to the treatment of the withholding taxes outlined above, the income tax imposed by a third country on the allocable profit of a permanent establishment of the CFC has to be credited against the domestic income tax levied on the foreign income. Of course, this is only true inasmuch as the profit of the PE is in the focus of the respective CFC taxation and therefore attributed to the domestic shareholder. This is irrespective of the fact whether the foreign country applies the credit method or the exemption method for the avoidance of double taxation since it would otherwise lead - in both cases - to a double taxation of income. The income is taxed in the residence country of the shareholder pursuant to the CFC rules on the one hand, and in the CFC country and (or) the PE country on the other. Thus, it can generally be concluded that the facts which were outlined above with respect to withholding taxes are equally true for income taxes levied on the profit of a permanent establishment.

6.9.3. Taxes Imposed by the Residence Country of the Shareholder

The question arises whether there should be any difference in the treatment between taxes imposed by a third country and taxes imposed by the country of the shareholder. Such a situation could exist where the CFC invests in the state of the shareholder and receives income which is subject to withholding tax, e.g. interest income or royalty income. Theoretically, taxes could also be imposed on the income of a permanent establishment of the CFC in the shareholder’s country. The latter situation can, at least theoretically, exist in all of the countries which apply CFC rules as long as the requirements for the creation of a permanent establishment are fulfilled.[272] Of course, a combination of permanent establishment taxation in the state of the shareholder and CFC taxation in the state of the shareholder is usually only possible if the income is subject to low taxation (which can be the case, for example, if the permanent establishment income is just a minor part of the overall CFC

[271] De Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 783).
[272] If the tax treaty follows the OECD-MTC, the requirements will be based on Articles 5 and 7 of the OECD-MTC.

income). However, there is no reason, in my opinion, why the income tax imposed on the income of the permanent establishment should not be credited against the income tax imposed under the CFC regime (if the permanent establishment income is included in the attributable CFC income). It seems that in such a situation the crediting of the income tax should be possible, for example, in Finland and Portugal.[273]

In any case, there is no reason - from my point of view - for a separate treatment with respect to the crediting of domestic taxes. The CFC is legally to be seen as the recipient of the - for example - interest income which is subject to a source based taxation in the form of a withholding tax. Nonetheless, the income is currently attributed to the shareholder and the overall tax burden has to be taken into account - in the same way as it was outlined for withholding taxes of a third country. In general, the crediting of taxes in the context of the CFC regime is required for the elimination of double taxation of income. If one agrees with the position that the current taxation of income should not have a penalty effect for the shareholder, but should merely lead to an immediate taxation of income, it is apparent that the relief from double taxation may not be restricted to the taxes imposed in the CFC state and third states. It is equally required to provide for a relief from double taxation caused by a source-based taxation in the state of the shareholder. In my opinion, any other approach would be inconsistent and would finally result in an "over-taxation" in the state of the shareholder.

6.9.4. Taxes Imposed by the CFC Rules of another Country

Another interesting question is whether – and to what extent – the CFC taxation of another country should be taken into account. This could be relevant in structures with several tiers where different companies located in different countries (with CFC taxation) are involved. This issue will be discussed below in the context of multiple tier structures.

6.9.5. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The insufficient crediting of taxes is another factor which can result in serious distortions and which might have an influence on the investment decision of the resident shareholder. This, of course, should not happen - at least not in those cases in which the system of current taxation is to be seen as more than just an anti-avoidance regime which tries to "penalise" certain investments. With respect to the tax credit system, I think a differentiation can be made between those CFC regimes

[273] See with respect to the rules in Finland: Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 201; see with respect to the rules in Portugal: Borges, National Report Portugal, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 540. It may be the case that the PE issue plays a more important role in entity approach countries than in transactional approach countries. The reason is that under an "all-or-nothing" approach even high-taxed income from minor activities might be included in the attributable income as long as the overall low-taxed (tainted) income prevails. Under the transactional approach, the income will be separated and only the low-taxed tainted income will be attributed to the shareholder. Nevertheless, the question may theoretically also play a role in transactional countries. In Germany, for example, it is clearly stated that also German taxes imposed on the CFC income can be credited (see section 12.1.2. of the Administrative Circular on the Application of the Foreign Income Tax Act).

which just provide for (or accept) the "usual" disadvantages of a tax credit system and those regimes which lead to additional CFC specific disadvantages.

The most important usual disadvantage of a tax credit system is the fact that foreign taxes imposed on the CFC income are not (or not completely) creditable against the income taxes imposed on the attributed income in the state of the shareholder. This, for example, can be due to negative income (or a tax loss carry forward) of the shareholder. This is a typical problem which not only exists in case of the application of CFC rules but also in case of dividends or in case of permanent establishments (if the income is not exempt from taxation). In this respect, one might be tempted to neglect the effect of double taxation by referring to the general "systematic effects" of the application of the credit method. However, taking into account the theoretical basis which was described earlier, i.e. the fact that such a system should - within a non-optimal scenario - lead to a safeguarding of competitiveness and an equal treatment of resident shareholders, it is not appropriate, in my opinion, to accept such a disadvantage. This all the more since the current taxation of income on a regular (yearly) basis does not really provide many possibilities for the shareholder of avoiding the double taxation of income. Thus, the approach under all of the existing CFC regimes, as shown above, is apparently the acceptance of such a usual disadvantage of the tax credit system.

The problem increases when the usual disadvantages are accompanied by CFC specific disadvantages, i.e. disadvantages which are solely caused by the application of CFC rules and which would otherwise not come up. For the shareholder, this has the effect that the likelihood of a penalisation increases. Hence, it must be concluded, in my opinion, that the regimes which create a serious risk of double taxation cannot, not even partially, fulfil the economic requirement of a neutral application of such regimes in order to safeguard competitiveness. Furthermore, the strict penalisation of investments in one situation (where the CFC regime is applicable) and the non-penalisation of investments in another situation (where the CFC regime is not applicable) do not support taxpayer equity. The regimes which provide for such additional disadvantages are outlined above. This is, for example, Hungary with a general non-acceptance of an indirect tax credit and Spain with the non-acceptance of an indirect tax credit in case of listed tax havens (see above). However, also the simple and common effect of a non-creditable withholding tax which is caused by the time lack between the current taxation of income and the subsequent dividend payment can clearly be seen as a problem which is directly linked to the system of current taxation of income - even though this should not be an issue if one follows the OECD approach.[274]

Overall, it should be clear that a regime which focuses on the current taxation of income, no matter whether it is a CFC regime or any other alternative regime, must provide for an appropriate tax credit system which ensures that the attributed income is not subject to double taxation or subject to any other serious disadvantage. If this is not the case, the system can only be considered a strict anti-avoidance legislation which accepts the unnecessary penalisation of investments and which neither safeguards competitiveness nor supports taxpayer equity. An insufficient tax credit system is a serious obstacle for a neutral system of taxation. However, only a neutral system of taxation can avoid the aforementioned penalty effects.

[274] See in more detail section 6.7.1. and paragraph 32.8. of the OECD-Commentary on Articles 23 A and 23 B of the OECD-MTC.

6.9.6. Conclusions Regarding the Relief for Foreign Taxes

The CFC taxation clearly focuses on the underlying income derived by the CFC – in most cases determined according to domestic tax rules – and not on the legal result actually derived by the foreign entity. That means the CFC rules ignore, to a certain extent, the foreign legal entity and just take into account the respective income. This is true for both approaches, the entity approach and the transactional approach, even though it is much more obvious in the latter case. Therefore, the credit method - which is the underlying method in the context of CFC taxation[275] - should be applied consistently and should take into account all income related taxes which have not already been credited on the level of the CFC. Technically, the tax credit in the residence state of the shareholder should encompass the corporate income tax which has to be paid by the CFC, i.e. reduced by the taxes already creditable against the corporate income tax of the CFC, and the taxes imposed in third countries (e.g. withholding taxes, taxes levied on the income which is allocable to a permanent establishment). The possibility of a deduction of those foreign income taxes from the attributable income instead of a crediting would lead to a treatment which is comparable to regular business expenses. However, this would have the consequence of a partial double taxation of income.

As already described earlier, economic principles and equity aspects require the taxation of the basic interest component instead of the (total) amount of CFC income. However, also in this case it is required that the system provides for a consistent relief from double taxation and, therefore, a relief for foreign taxes imposed on this particular part of attributed income.

6.10. Multiple Tier Structures and CFC Rules

6.10.1. The Indirect Participation in a CFC

Due to the fact that CFC rules have to be seen as anti-avoidance measures in order to prevent a domestic tax base erosion, it is quite obvious that the focus of CFC rules cannot be restricted to a *direct* participation in a foreign company. Otherwise, it would be relatively easy to circumvent the current taxation of CFC income by simply interposing another foreign company - in a country without CFC legislation - between the parent company and the low-taxed foreign company which does not fulfil the requirements of the respective CFC rules. Even if one takes the position that CFC legislation is *not* - in the first instance - an anti-avoidance legislation but just a consistent method to ensure capital export neutrality related to certain activities, it should not be hindered by the fact that one or more legal entities are interposed between the domestic shareholder and the company which derives passive income. Therefore, it is a common feature of the European CFC rules to cover indirect shareholdings by the relevant CFC taxation with the effect that the activity of an indirect lower tier subsidiary can equally lead to an income attribution to the domestic shareholder.[276]

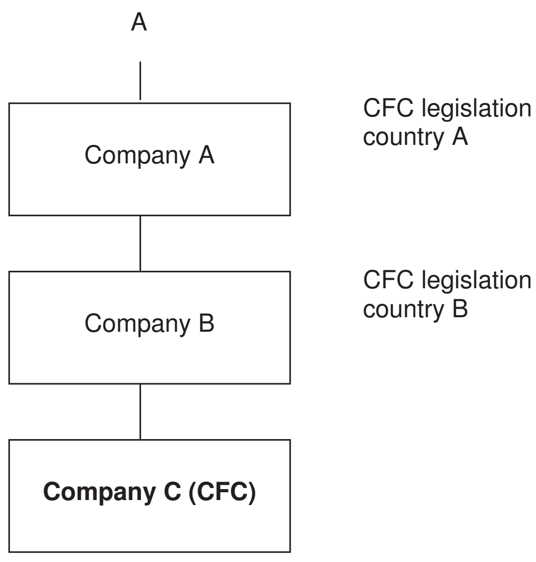
[275] In general, CFC taxation requires the application of the credit method. However, the provisions of a tax treaty sometimes allow the application of the exemption method to certain passive income, as in case of the former CFC system in Germany.

[276] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 43.

6.10.2. The Multiple Application of CFC Rules and Similar Measures

The general application of CFC rules to indirect shareholdings makes it theoretically possible that a certain activity is in the focus of the CFC rules of two or more countries. In principle, this can be true for all of the countries examined in this chapter. One should not forget that especially multinational groups combine certain inter-company activities which are often considered to produce base company income or other passive income which is subject to CFC taxation. Those multinational groups often have complicated structures with several tiers and a CFC can therefore have several direct and indirect shareholders situated in different countries but still being part of the same international group.[277] However, due to the purpose of safeguarding the domestic tax base, the concept of CFC taxation is typically quite "egoistic", i.e. each country which follows such an approach tries to avoid the shifting of its own domestic income to low-tax countries. All of these countries concentrate on the source of income but they are, in principle, not really interested in the question where the capital ultimately comes from. There is, to my knowledge, no European CFC regime which considers, e.g. for the question whether the CFC rules should be applicable or not, the (current or future) tax burden imposed on the CFC income on a *higher* group level.

<u>Figure 12:</u>



There are several difficulties involved in the application of CFC rules of two or more countries which focus on the same foreign activity. This will be outlined in the following.

[277] The fact that the European CFC regimes often already apply to relatively small percentages of shareholding increases the number of situations where an "overlap" can exist.

6.10.2.1. The General Recognition of the Lower Tier CFC Rules

As mentioned above the CFC legislation is directed towards certain types of income derived by a direct or indirect participation situated in a low-tax country. Therefore, the CFC rules do not deal with the question whether there is any similar legislation in place on a higher level, i.e. the level of the direct and indirect shareholders. For example, country B (in the figure above) is - in principle - only interested in the safeguarding of its own domestic tax base. The CFC legislation is therefore applicable to the income of company C without taking into account a comparable legislation in country A. It is certainly difficult for country B, and in some cases even impossible, to know the exact shareholder structure on a higher level and to gather the necessary information in this respect.

From the perspective of country A, it is equally important to avoid a domestic tax base erosion. However, the CFC rules of country A do not apply to country B - since it is not a low-tax country - but to the income derived in country C. That means, both countries (A and B) theoretically apply their respective CFC legislation on the income derived in country C. However, to the extent that a certain amount of CFC income is theoretically taxable in both countries A and B, the question arises whether the CFC taxation of one country should have priority over the CFC taxation of the other country or, at least, whether one country should take into account the CFC legislation of the other country and refrain from its own CFC taxation or to provide measures for the avoidance of a possible double taxation of income caused by the simultaneous application of CFC rules. In principle, if one accepts the concept of CFC taxation, it should be clear that one cannot give priority to either the CFC legislation of country A or country B. Both countries have a legitimate reason for the application of their respective rules which is the safeguarding of their own domestic tax base. However, there are - in my opinion - convincing arguments according to which the parent company in country A should take into account the CFC taxation on a lower level, i.e. in country B (country A should also take into account the taxes imposed in country C - to the extent that the taxes are not already taken into account in the intermediate country B).

Firstly, and based on the reasoning above, it is certainly easier for company A to receive information from the company in which it has invested, at least if it is a substantial shareholding, than the other way around. Company A has to make a number of decisions in relation to its participation, e.g. the determination of the result of company B based on the commercial accounts, the decision whether the profit should be distributed or carried forward to the subsequent year, and the approval of the management of the company. In addition, the shareholder (company A) usually has the right to receive information from company B - and the latter company has the corresponding legal obligation to provide this information - at the shareholders' meeting. In contrast thereto, there is typically no comparable legal obligation for the shareholder (company A) to inform company B about its (legal) situation. Of course, if the shareholder has a substantial participation in company B, it is likely that there is an appropriate information exchange between company A and company B, but this is not self-evident. Hence, if there is no legal obligation for the shareholder to provide information, it may be difficult for country B to gather the information required. In any event, if the latter country has no proper instruments available to gather such information, it excludes the possibility that this can be a stable basis for a decision of country B on the application or non-application of the domestic CFC rules.

Secondly, if country A does not refrain from taxing the CFC income, it is from a technical perspective easier to avoid a double taxation by crediting the income tax levied in country B against the income tax levied in country A on the same amount of CFC income.

Thirdly, the most important aspect seems to be the fact that the application of CFC rules reflects the concept of taxing income pursuant to the principle of capital export neutrality. Hence, it is the nature of CFC legislation to include foreign income in the domestic tax base. This ensures that foreign income and domestic income are (currently) taxed at the same rate. The non-taxation of foreign source income in country B - because of a current taxation in country A - would be in conflict with the principle of capital export neutrality, because resident companies with domestic income would be taxed at a higher domestic rate than resident companies with foreign income derived by a CFC in country C. However, this does not necessarily mean that the income is taxed at a lower rate: if the income is subject to CFC taxation in country A and the tax rate in the latter country is at least as high as in country B, the foreign income is (ultimately) not subject to lower taxation. Nonetheless, only the inclusion of foreign income and the taking into account of the taxation on the lower group level (including a possible CFC taxation) would clearly reflect the concept of world-wide taxation and therefore the principle of capital export neutrality.

However, from a mere anti-avoidance perspective it is questionable whether there is any necessity to tax the amount of CFC income in country A which is already taxed in country B if the tax rate of the latter country is above the critical tax rate stipulated by country A. If the purpose of CFC legislation is to prevent a tax base erosion which can be triggered by the attractiveness of a certain low-tax country, this will already be prevented by the existence and the application of the CFC rules of country B. At least, this is true with respect to the overlapping CFC income which is in theory subject to tax in both countries A and B. As a first step, it must be concluded - in my opinion - that the higher tier CFC legislation should recognise and consider, in one way or another, the CFC taxation of the direct and indirect subsidiaries on a lower group level. Although this is a general - and in my opinion important - conclusion, it must be clear that this, by itself, does not solve all of the problems related to multiple tier structures and the multiple application of CFC rules and similar measures.

6.10.2.2. Problems Caused by the Multiple Application of CFC Rules and Similar Measures

It is quite obvious that the CFC rules of the countries which apply such regimes do not really fit together. This is mainly due to the fact that the decisive elements of CFC regimes are influenced by domestic legislation, especially tax legislation. This is not only true for the income determination rules but also for the criteria of low-taxation and the relevant CFC income (passive income and base company income). Furthermore, the general approaches (entity approach and transactional approach) can lead to a completely different outcome under the respective CFC regimes.

a.) The application of entity and transactional approaches

One important reason for deviations lies in the different approaches, i.e. the entity approach and the transactional approach. As outlined earlier, Member States which follow a transactional approach are Denmark, Germany, Spain and Lithuania. All of the other CFC regimes within the European Union follow an entity approach. The entity approach takes into account the overall activity of the CFC and certain other elements in order to decide whether the CFC income is exempt from current taxation or not. It is often required that the foreign company carries out mainly an industrial or commercial activity and mainly in the state or territory where the foreign company is established (e.g. in France, Italy, Portugal). If this requirement is fulfilled, the CFC income is completely excluded from current taxation. Otherwise, the whole income will be allocated to the resident shareholder and this also includes income components which are theoretically related to active business activities. This “all-or-nothing” approach has the effect that a small increase in the passive activities within a foreign company can lead to the total income being subject to CFC taxation, and a small decrease in such activities can lead to a complete exclusion. In contrast thereto, the transactional approach - at least in its purest form - is only directed towards passive income elements and does not encompass any income from active business activities. This leads to a clear separation of income elements. However, the existing base company rules can have the effect that activities which are normally seen as active activities are considered to be tainted income under certain circumstances (e.g. in Germany). Nonetheless, the tainted income is clearly separated and there is no such “all-or-nothing” approach. It is therefore possible that the application of a CFC legislation which follows an entity approach and a CFC legislation which follows a transactional approach leads to a deviation in the allocable income. At least, this is true if the business of the foreign company (the CFC) encompasses different activities and is not only limited to one single passive activity. The problem is further increased with the number of additional tiers and, of course, with the involvement of additional CFC regimes. One could conclude that the more tiers involved, the more problems may come up.

b.) The application of entity approaches

This does not mean, however, that two (or more) countries which follow the same approach fit together. There is a substantial number of possible deviations in case of the entity approach. This can be, *inter alia*, the business activity itself, the requirement that the business activity must be carried out on the local market, the respective threshold in this context, and the variety of exemptions from the current taxation of income. For example, the fact that certain activities have to be carried out “mainly” on the respective local market is not always to be understood in the same way. For example, the Portuguese rules require that at least 75 percent of the income of the CFC is derived from activities in the local market in order to be exempt from CFC taxation.[278] In contrast thereto, the Finnish rules require a share of local income of at least 50 percent[279] and the (revised) French rules include an additional “passive income test” which, *inter alia*, leads to an income allocation if more than 20 percent of the income of the CFC is derived from the management of financial assets and the exploitation of intangible assets.[280] Hence, even though all of the three states follow,

[278] Section 57-B of the Portuguese Corporate Income Tax Act; de Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 779, 780; de Sousa da Camara / Núncio, Portugal’s 2002 Budget Bill Revises Capital Gains Tax Regime, Tax Analysts Tax Document Service 2001, Doc 2001-28988.
[279] Section 2 (2) of the Finish CFC Act.
[280] New Article 209 B of the French Tax Code; see Simmons & Simmons, EU Tax Update, January 2005, page 3; Herbert Smith, New Controlled Foreign Company (“CFC”) Rules, French Tax Briefing, January 2005, page 6; Tillmanns, Steueränderungen Frankreich 2004/2005, Internationale Wirtschafts-Briefe, Fach 5, Gruppe 2, page

in principle, an entity approach, it is apparent that the classification of CFC income and the decision whether the income of the CFC is exempt from current taxation or not can be totally different. In addition, some countries provide for exemptions from CFC taxation which are non-existent in other countries. For example, the United Kingdom CFC regime provides for a substantial number of exemptions. However, the exemption based on the motive test is, at least in this particular form, not available in other countries which follow the entity approach. The same is true for the exemption based on the acceptable distribution policy and the exemption for publicly traded companies. Thus, the differences in the entity approach CFC regimes can very well lead to a current taxation of income according to the CFC regime of one country, but to a complete exemption from current taxation according to the CFC regime of another country.

c.) The application of transactional approaches

The transactional approach focuses on the respective income, i.e. the qualification as passive income (tainted income) or active income. It is obvious that even in case of the typical passive income, e.g. interest income, deviations are possible. For example, under the Danish CFC rules the financial income derived by the foreign company will only be attributed to the Danish shareholder if it exceeds one-third of the total net taxable income calculated pursuant to the Danish rules. This approach allows for a substantial amount of passive income to be derived abroad without any immediate CFC taxation. This will not be the case in Germany, Spain and Lithuania where the threshold is either much lower or is related to another basis. In addition, and with respect to other types of passive income, the aforementioned transactional countries have a different separation between active-passive activities. For example, pursuant to the German CFC rules, the exploitation of intangible assets is classified as tainted income if the tangible assets are not self-developed by the CFC. In fact, it does not matter whether the recipient of the services is a German resident or not. The Spanish approach is totally different in this respect and focuses on the question whether, in general, the payments for services provided by the CFC lead to a deduction from the Spanish tax base. The latter question, however, does not play any role under the German CFC regime. Hence, the concepts are different and it is absolutely possible that the transactional countries will end up with a different amount of allocable CFC income in case of a multiple CFC taxation - just because of the fact that they target different types of transactions.

d.) The application of CFC taxation and similar anti-avoidance measures

A multiple tier structure in which a country is involved which applies a CFC taxation and another country which applies a similar anti-avoidance measure is an additional source of deviations and possible double taxation. Similar anti-avoidance measures are - for example - those which switch from a participation exemption to a credit system if certain requirements are fulfilled. Such measures do not tax the income of the foreign company on a current basis but they provide for a subsequent taxation in the residence country of the shareholder. For example, Belgium applies a “dividend-received deduction” which leads to a 95 percent exemption of dividends received from a qualifying subsidiary. However, the reduction can only be applied if the company paying the dividend is not established in a country where the common tax

1417 et seq. (1420); see with respect to the former CFC rules: Regulations 4H-3-98 of April 17, 1998, nos. 198-202.

regime is considerably more favourable than in Belgium.[281] Comparable rules exist in Austria.[282] The "time lack" between the CFC taxation in one country and the subsequent dividend taxation in the other country can lead to a double taxation of income (I will go into more detail regarding such a situation in the example below).

e.) The application of CFC taxation and the credit method on subsequent dividends

Of course, the problem can also exist if a "regular" credit-country is interposed between the country which applies its CFC taxation and the CFC itself. In the same way as described above, the current taxation pursuant to the CFC rules and the subsequent taxation of dividends according to the credit method on the intermediate level can create a double taxation of income. For example, let us assume that a German parent company has a subsidiary company in the United Kingdom and the latter company has, in turn, a subsidiary company in a low-tax country (CFC). It may be the case that the CFC is exempt from current taxation in the United Kingdom (entity approach), but part of the (passive) income of the CFC is subject to current taxation according to the German CFC regime (transactional approach). If it is further assumed that the CFC does not (or perhaps cannot) distribute any income to the shareholder, the income will be subject to tax - year by year - in the hands of the German (grand)parent company, but not in the United Kingdom. The income tax levied in the CFC country will be credited, but no United Kingdom income tax (because at that point in time there is no income tax imposed on the CFC income in the United Kingdom). If, several years later, the CFC distributes income to the intermediate company in the United Kingdom, the distribution will be subject to income taxation in the United Kingdom - with the effect that the overall tax burden on the distributed income increases. The tax credit system in the United Kingdom will not take into account the previous CFC taxation on a *higher level* in Germany. The subsequent distribution of the intermediate company in the United Kingdom to the German company will be exempt from taxation in Germany.[283] Hence, if the country which applies the CFC regime - in this example Germany - does not provide for a relief by way of (retroactive) adjustment, the double taxation of income might lead to a substantial increase of the overall tax burden. I will come to that aspect - and the approach of some of the countries which apply CFC regimes - in more detail below.

f.) The application of CFC taxation to permanent establishments and partnerships

In general, CFC rules are applicable to legal entities. However, it can be the case that - for example - a partnership is treated as a separate taxable entity in one country but as a transparent entity in the other (classification conflict). Thus, one country applies its CFC taxation on the foreign income and the other country taxes the income of the partnership on the basis of its domestic rules for permanent establishments (credit method) or exempts the income from domestic taxation (exemption method). Furthermore, some of the countries, such as France and Lithuania, do not limit the application to separate taxable legal entities but generally apply the CFC taxation to

[281] See Tahon / Bogaerts, Belgium: Amendments to the Participation Exemption Regime, Tax Planning International Review (December) 2002; in addition, certain dividends are explicitly excluded from the dividends-received deduction (see Article 203, paragraph 1, 1 and 2-5 Belgium Income Tax Code).
[282] Section 10 (3) of the Austrian Income Tax Act; see also Tax News Service, 43/2002, October 11, 2002.
[283] Leaving aside the add-back of 5 percent of the distribution to the German tax base.

partnerships and permanent establishments.[284] It seems that this is the case where the income of partnerships and permanent establishments is otherwise exempt from domestic taxation (exemption method). These countries apparently see the necessity to deal with this issue in the context of CFC taxation. Other countries, such as Germany, have separate legislation which switches from the exemption method to the credit method in certain cases in order to avoid passive foreign source income of partnerships and permanent establishments being exempt from domestic taxation.[285] At least in one European country, namely in Italy, the CFC taxation is only applied to permanent establishments (or partnerships) of subsidiary companies but not to permanent establishments (or partnerships) of the domestic company.[286] It is obvious that such a "mixture" of different approaches may lead to conflicts in a multiple tier structure.

g.) The determination of income

Another aspect which is quite important is the fact that CFC rules typically require the foreign income to be calculated according to the domestic tax rules.[287] This is not only true for the verification of the effective foreign tax rate but also for the determination of the attributable income. Even though it may be the case that the general accounting rules of two or more states are similar, it is unlikely that the rules of determining the income for tax purposes is identical - given the fact that a system of income taxation is very much influenced by national interests. Therefore, it may be assumed that even in case of limited activities of a CFC there will be differences in the determination of the attributable income - compared to the CFC itself and compared to the CFC taxation of another state. As already outlined earlier, the approach among the Member States is to ignore the tax base calculated according to the residence state of the CFC and to make a separate calculation - based on domestic legislation - only for the application of the CFC regime. In fact, it seems that there is - apart from Hungary - no Member State which allows the income attribution based on the income determination of the residence state of the CFC. Furthermore, there is no Member State which accepts the income determination according to the CFC regime of another Member State. Hence, it is absolutely clear that the isolated approaches of calculating the amount of income attribution is an additional source of double taxation.

h.) The relevant tax rate and the percentage of shareholding

The fact that the countries which apply such CFC taxation have different thresholds with respect to the low-taxation requirement and the percentage of shareholding can

[284] See, for example, the CFC taxation in Lithuania (Bernatonis, National Report Lithuania, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 394) and the French CFC taxation (see Thill / Mihac, French CFC Regime Examined, Tax Notes International 1999, page 779).

[285] For example Germany, section 2 a of the German Income Tax Act. See also the great number of activity clauses in the German tax treaties (see Wassermeyer, Das Wirrwarr mit den Aktivitätsklauseln im deutschen Abkommensrecht, Internationales Steuerrecht, 2000, page 65 et seq.).

[286] The Italian CFC legislation is not applicable to permanent establishments of an Italian company. However, if a foreign subsidiary of an Italian company, e.g. in the Netherlands, has a permanent establishment in certain low-tax countries or territories, e.g. on the Isle of Man, the Italian CFC rules will apply to the income of the permanent establishment but not to the Dutch subsidiary itself (see Conci / Kessler / Puricelli / Schommer, Die Hinzurechnungsbesteuerung in Italien, Internationales Steuerrecht, 2002, page 763 et seq. (764).

[287] See in this respect Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 58.

have the effect that two (or more) CFC rules are not consistently applicable over a certain period of time. That means the CFC rules step in and step out depending on the changes in the tax rate or the percentage of shareholding. It was outlined earlier that a variety of different thresholds exists and it would be a mere coincidence if the required level of taxation and the minimum shareholding for the application of the CFC rules of two or more countries were be the same.

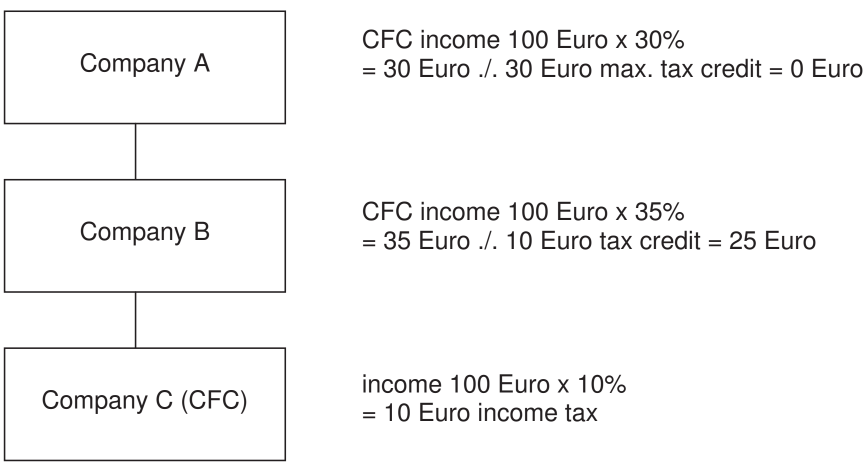
6.10.2.3. Cases of Possible Double Taxation Caused by the Multiple Application of CFC Rules and Similar Measures

It should be clear that not all of the aforementioned aspects lead to a double taxation of CFC income. However, in the following I will present some examples where the simultaneous application of CFC regimes and similar situations in a multiple tier structure can lead to double taxation of income. Of course, this is by no means concluding, but it gives an impression of the problems which can arise in such situations.

a.) Tax credit for taxes imposed by the CFC taxation of another country

Similar to what was outlined earlier with respect to the crediting of taxes imposed on the underlying income in third countries and in the CFC country, it is equally important to take into account the taxes imposed according to the CFC rules of another country on a lower group level.

Figure 13:



The example shows that only in case of the consistent application of an ordinary tax credit system by both countries which apply a CFC taxation (countries A and B) a double taxation can be avoided. This is certainly the simplest case of a multiple tier structure since there is neither a tax loss involved nor does the tax base deviate on the respective company levels. In such a situation, the overall tax burden will always be equal to the tax burden of the country which has the highest tax rate.[288] However, if country A did not take into consideration the CFC taxation in country B (but only the taxation in country C), the overall tax burden would drastically increase from 35 percent to 55 percent.[289] Therefore, the higher tier CFC taxation should in general provide for an ordinary tax credit in a situation where the CFC income is already taxed pursuant to another country's CFC regime on a lower group level.

In fact, only very few countries provide for such a relief from a lower tier CFC taxation. Finland and Germany treat the taxes imposed pursuant to the CFC rules of another country as a foreign tax paid by the CFC itself, and allow an ordinary tax credit against the domestic income tax in Finland and Germany.[290] There are, at least to my knowledge, no other countries which provide for such an immediate relief from double taxation caused by lower tier CFC taxation. There may be cases of indirect relief which are related to subsequent dividends, like in case of Italy where the Italian taxpayer can claim the tax credit for the taxes paid abroad by the non-resident intermediate on the exempted distributed profits, but this is not comparable to the tax credit system in Finland and Germany.[291] The same is true for cases in which a relief may only be granted by way of motive exemption pursuant to the applicable CFC legislation or by way of mutual agreement procedure based on a double tax convention. For example, pursuant to the United Kingdom Inland Revenue Guidance Notes on CFCs, a motive exemption may be granted when the CFC taxation on the intermediate level is broadly comparable to the United Kingdom taxes which would be imposed on the attributed income.[292] In France, relief may be granted through mutual agreement procedure.[293] However, the relief through motive exemption and in particular through mutual agreement procedure is something which includes a high degree of uncertainty about the possible outcome. The mutual agreement procedure cannot be seen as a clear concept of relief from double taxation but rather as a procedure for exceptional cases. In my opinion, what is really required is a legal concept which is stipulated in the respective CFC legislation and which gives certainty to the taxpayers. I consider the ignoring of the CFC taxation of another country to be as critical as the ignoring of the taxation in the CFC country itself. Hence, if a system provides for relief from double taxation of taxes imposed in the CFC country - as is the case (in one way or another) under all of the European CFC regimes - it should self-evidently also be the case for the taxes imposed according to the CFC regime of another (intermediate) country.

---

[288] In this case, the intermediate company B has the highest tax rate (35%). However, the result would be the same if the tax rates between the countries A and B were reversed. This is basically due to the mechanism of an ordinary tax credit system.

[289] 10 Euro (country C) + 25 Euro (country B) + 20 Euro (country A) = 55 Euro.

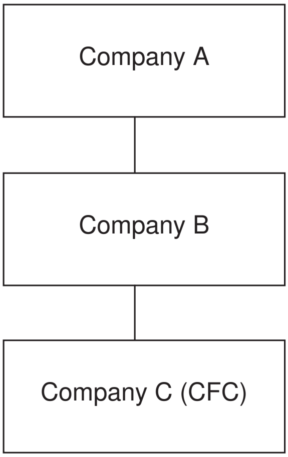
[290] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 66, 67. Outside of Europe it is New Zealand which provides for a similar relief. See also Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 201.

[291] See with respect to Italy: Favi, National Report Italy, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 361.

[292] Friel, National Report United Kingdom, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 890; paragraph 3.6.38 of the United Kingdom Inland Revenue Guidance Notes on CFCs.

[293] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 67.

Figure 14:



entity approach
CFC income 100 Euro x 30% = 30 Euro
./. 25 Euro (A and B) = 5 Euro (in case of cross-crediting)

transactional approach
CFC income 60 Euro x 35% = 21 Euro
./. 6 Euro (C) = 15 Euro

income 100 Euro x 10%
= 10 Euro income tax

In the alternative scenario country A follows an entity approach and country B follows a transactional approach and attributes only part of the income of company C (the tainted income) to the resident shareholder. However, the income calculation in all of the countries is - for the reason of simplification - identical. Country A could be, for example, Finland and the transactional country B could be Germany.[294] The latter country would typically allow only a partial tax credit of 6 Euro - the part which relates to the income attributed to company B.[295] In order to avoid any double taxation of income, it would be necessary for country A to provide for a tax credit of the amount of taxes imposed in the intermediate country and the (non-credited) amount of taxes imposed in the CFC country. Thus, if the intermediate country imposed 15 Euro (after crediting 6 Euro income tax of country C) and country C imposed an amount of income tax of 10 Euro, it would be necessary - for a complete elimination of double taxation in country A (Finland) - to credit 25 Euro. If this is the case, the taxes imposed in country A of 30 Euro would be reduced by 25 Euro to a total of 5 Euro. This, however, requires the cross-crediting of an amount of 3 Euro (because the tax rate in country A is lower than the tax rate in country B on the same amount of income). Hence, the cross-crediting would result in a total tax burden of 30 percent whereas the situation without cross-crediting would result in a total tax burden of 33 percent.[296] Thus, country A has to take into account taxes paid in both countries B and C in order provide for an appropriate tax relief in this scenario. Again, this is a

[294] The tax rates used in the example do not reflect the actual income tax rates of Finland and Germany. However, in order to have consistent examples, it is useful to stick to the 30 percent tax rate for country A and 35 percent for country B.

[295] 10 Euro income tax (country C) x 60% = 6 Euro.

[296] An amount of 6 Euro was credited in country B (100 Euro x 60% x 10% income tax) against the income tax imposed on the attributable amount of 60 Euro. However, country A attributes all of the income of company C to the resident shareholder. The whole amount of 100 Euro has theoretically to be split up into an amount of 60 Euro and an amount of 40 Euro. The 60 Euro attributable income is subject to an income tax of 18 Euro and a maximum of 18 Euro can be credited against the income tax (without the possibility of cross-crediting). The 40 Euro attributable income is subject to an income tax of 12 Euro. However, there is no income tax levied on this portion of income in country B but only an amount of 4 Euro in country C (100 Euro x 40% x 10% income tax).

relatively simple case since it is assumed that the income determination rules in all of the three countries are identical. The case can become highly complex and problematic if - in addition to the different approaches - the income calculation rules differ in countries A, B and C.

The opposite example, i.e. where country A follows a transactional approach (e.g. Germany) and country B follows an entity approach (e.g. Finland), includes similar aspects. However, in this case the income tax of country C should normally be fully credited against the income tax of country B (due to the identical tax base under the entity approach - and under the assumption of identical income determination rules).

b.) CFC tax credit and negative income in the countries with CFC taxation

The problems of a CFC tax credit in combination with tax losses (or a tax loss carry forward) is basically similar to the problems outlined earlier in the context of a “normal” tax credit. However, it is obvious that the likelihood of double taxation increases with the number of companies involved and the number of CFC rules applied to the respective CFC income. If only one company in the chain suffers a tax loss (or has a tax loss carry forward available), a partial double taxation will be the result.

Figure 15:

	Scenario 1	Scenario 2
Company A	CFC income 100 but overall tax base negative = no tax credit	CFC income 100 x 30% = 30 Euro
Company B	CFC income 100 x 35% = 35 ./. 10 tax credit = 25 Euro	CFC income 100 but overall tax base negative = no tax credit
Company C (CFC)	income 100 x 10% tax = 10 Euro	income 100 x 10% tax = 10 Euro

In the first scenario, the income tax paid in country C can be credited against the income tax paid in country B, i.e. the next higher level. Since the parent company A suffers a tax loss (or has a tax loss carry forward available) it will not pay any domestic income tax with the result that there is no possibility for a tax credit. However, the outcome of the first scenario is dependent upon several factors. Under most CFC regimes, the income attribution will reduce the domestic tax losses (or the respective tax loss carry forward) with the effect of a partial double taxation, because the tax losses which will be offset against the attributed CFC income cannot be used for a reduction of the domestic tax base in subsequent years. The amount of loss utilisation - and therefore the degree of double taxation - depends on the CFC regime of country A. If the latter country provides not only for a deduction of the taxes imposed in country C but also for the taxes imposed in country B, it may be the case, like in Germany, that the attributed amount can be reduced from 100 Euro to 65 Euro, i.e. by allowing the deduction (but not the credit) of 35 Euro income taxes from the attributable CFC income in country A. However, if the CFC taxation on the intermediate level is not taken into account at all, as is the case in a substantial number of countries (see above), the attribution may only be reduced to 90 Euro by deducting the income taxation in country C. The "worst case," of course, is to ignore the taxation in country B and country C. This would result in an income attribution of 100 Euro. In the latter case, the overall tax burden including the disadvantage of the tax loss reduction in country A (non-discounted) amounts to 65 Euro.[297] However, even in the "best case" of an attribution of 65 Euro, the combination of CFC taxation in country A and country B results in an overall tax burden of 54.50 Euro.[298] Given the fact that the highest tax rate in the structure is 35 percent, the outcome, in my opinion, cannot be satisfactory.

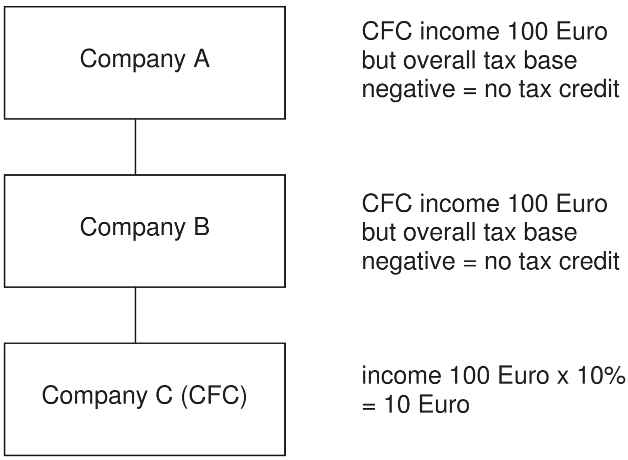
In the second scenario, there are at least as many theoretical possibilities as in the first scenario. Of course, the approach in the "loss country" is, again, of great importance for the determination of the amount of double taxation. Here, it is advantageous if the "intermediate" country provides a roll-over of the income taxes imposed in country C. This is the case, for example, in Portugal.[299] However, the additional question is how country A deals with the loss-making intermediate company in combination with the (additional) CFC taxation. As already outlined earlier, almost all of the countries provide a tax credit for income taxes imposed in the CFC country (see above). The crediting of the 10 Euro income tax in country A is therefore, in principle, not problematic. What is problematic, however, is the fact that the CFC taxation in country B usually results in an offsetting of tax losses and does not create any (immediate) income tax which might be offset in country A. Thus, the CFC taxation in country B will lead to a tax payment in a subsequent period, but not in the period of income attribution. The problem is that Finland and Germany - the countries which follow the exceptional approach of providing a credit for the taxes imposed on the CFC income (on the intermediate level) - do not, at the same time, provide for subsequent adjustments for taxes payable in country B at a later point in time. In other words, even those countries which provide, in principle, for a relief from double taxation caused by the CFC taxation on the intermediate level fail to solve the problem if tax losses are involved. Hence, it is apparent that the involvement of tax losses in country A results in an over-taxation of income - similar to the first scenario.

Of course, several additional scenarios are thinkable and it seems that the European Member States which follow a concept of CFC taxation do not really provide for an appropriate system of relief from double taxation. Moreover, it shows the dilemma of a multiple tier structure: in a situation where only one country applies its CFC rules to a low-tax country, the effect with respect to the losses will be the same, but the additional tax burden of the foreign company will be comparably low (if it is only applied to low-tax countries). In a multiple tier structure where two or more CFC rules are applied, the tax burden will be increased to a "regular level" and - in addition - the

[297] 10 Euro (country C) + 25 Euro (country B) + 30 Euro (country A – non-discounted) = 65 Euro.
[298] 10 Euro (country C) + 25 Euro (country B) + 19.50 Euro (country A – non-discounted) = 54.50 Euro.
[299] De Sousa da Camara, National Report Portugal, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 783.

domestic tax loss(es) will be reduced. The maximum disadvantage in a situation where two different CFC rules are applied is certainly a scenario where both countries (A and B) suffer tax losses (or have tax loss carry forwards available) and are therefore unable to credit any income tax. In such a scenario, the amount of tax losses which could be utilised in subsequent years would be decreased by the attributed CFC income in both countries.

Figure 16:



Without the possibility of a tax credit in countries A and B the amount of double taxation - and therefore the overall tax burden - would rise dramatically. In a "worst-case scenario," the tax losses in both countries A and B are reduced by 100 Euro. This might be the case when the income tax imposed in state C is not deducted from the income attributed to company A and company B. This would have a negative effect of 30 Euro and 35 Euro, respectively, of non-discounted future income tax. The overall disadvantage would amount to 75 Euro[300] Taking into account an additional tier, i.e. an additional CFC legislation involved, the overall disadvantage could easily exceed the attributed CFC income. It is quite obvious - in my opinion - that such an immense double taxation of income cannot be acceptable. However, even if the amount of income attribution is limited to 90 Euro in country A and country B (100 Euro minus 10 Euro income tax in country C), it will not significantly reduce the amount of double taxation. Effectively, it would result in an overall tax burden of 68.50 Euro.[301] As already described earlier, the problem of tax losses and CFC legislation could - at least partly - be solved by a system which provides for a carry forward of the creditable income tax. However, there is no CFC regime, according to my knowledge, which provides for a relief from double taxation in country A which is caused by the reduction of the tax losses in the intermediate country (country B).

300 10 Euro (country C) + 35 Euro (country B – non-discounted) + 30 Euro (country A – non-discounted) = 75 Euro.
301 10 Euro (country C) + 31.50 Euro (country B – non-discounted) + 27 Euro (country A – non-discounted) = 68.50 Euro.

The result is also interesting from another perspective: the respective CFC regime leads in most cases to a kind of “positive fiscal consolidation.” That means the positive CFC income is attributed to the resident shareholder with the effect of a reduction of the negative domestic tax base. In turn, there is typically no “negative fiscal consolidation,” i.e. the negative CFC income will not be taken into account directly for the determination of the domestic tax base. In such a multiple tier structure each consolidation will be made separately - always between the individual CFC regime and the (directly or indirectly held) CFC. The “positive fiscal consolidation” can be added together with the number of “CFC pairs” (CFC regime and CFC income) and can therefore lead to a considerable disadvantage within one single group of companies.

It was mentioned earlier that only very few countries provide for an appropriate relief from double taxation caused by an additional application of CFC rules in another country.[302] It seems that only Finland and Germany credit the income taxes imposed on the intermediate level. However, since these countries provide for a relief through a “regular” ordinary tax credit system, it is obvious that relief from double taxation of CFC income cannot be achieved in cases where a domestic tax loss is involved, either in the country of the parent company (country A) or the lower tier subsidiary company (country B), or in both countries at the same time (countries A and B). At least, this is true if one follows the approach that the reduction of a domestic tax loss carry forward can lead to a double taxation of income. In my opinion, one has always to take into account that the domestic tax losses can be carried forward and can in theory lead to a reduction of positive taxable income in subsequent years.[303] Any attribution of CFC income limits the possibility of a future offsetting of income or makes it even completely impossible. In my opinion, the concept of CFC taxation should take such “loss scenarios” into account and should provide for a more flexible relief from double taxation of income. Otherwise, the concept of CFC taxation goes much too far and can lead to a massive “over-taxation.” However, the question of possible alternatives will be discussed later on in more detail.

c.) CFC tax credit and negative income in the country of the CFC

The situation where the CFC itself suffers tax losses is not free from the risk of double taxation. The main problem here is - in my opinion - the tax loss carry forward limitation in the countries which apply the CFC taxation and in the CFC country itself. For example, if the countries A and B apply their domestic tax loss carry forward limitations on the negative CFC income of company C, this can result in a maximum of three different time limits on the same amount of negative income. The negative CFC income might be offset against positive CFC income in subsequent years according to the legislation of one country but not according to the legislation of the other(s) - due to the existing time limit. This is not a specific multiple tier problem, but the multiple application of CFC rules increases again the likelihood of a double taxation of CFC income. Similar to the aforementioned situations, the offsetting of

[302] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 66, 67.

[303] Of course, sometimes the possibility of a tax loss carry forward is limited in time and a tax loss utilisation can be impossible. However, this does not change the reasoning. The question whether the tax loss can actually be used can only be answered at a later point in time - this can be many years after the CFC income attribution. Furthermore, it has to be added that some of the counties which apply a CFC taxation provide for a limited tax loss carry back.

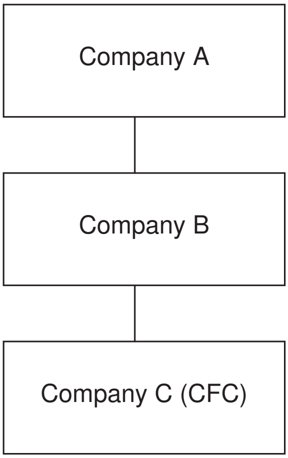
positive income with negative income does not trigger any income taxation in the respective year but reduces the tax loss carry forward - for example - in countries A and C. However, if the tax loss carry forward has already expired in country B, the attributed income will be taxed in country B with 35 percent - without any possibility of a tax credit (because there is no income tax imposed (yet) in country C which could be credited). This can result in a situation where the tax loss carry forwards existing in countries A and C are actually irrelevant, since the overall tax burden is 35 percent - with or without a tax loss carry forward in countries A and C.[304] The more countries are involved, the higher the probability that there are countries involved with a tax loss carry forward limitation. The country with the shortest tax loss carry forward period therefore influences the overall taxation of the international group. Thus, there is an increased likelihood that the positive CFC income is taxed before the existent tax loss carry forwards are actually utilised. Among the European Member States with CFC regimes there are still countries which have a (general) tax loss carry forward limitation, e.g. like in Spain (15 years), Italy (5 years) and Portugal (5 years). Sometimes, however, the possibility to carry forward negative CFC income for a future offsetting with positive CFC income is even more restricted than the regular (domestic) tax loss carry forward. In Finland, for example, the general tax loss carry forward period is 10 years. The possibility to carry forward negative CFC income, however, is limited to five years.[305] In Estonia, the carry forward is limited to seven years.[306] In Portugal, for example, a carry forward of negative CFC income is not allowed.[307] Hence, there are a number of possibilities in a multiple tier structure which might finally result in a double taxation of income.

d.) Double taxation caused by the application of CFC rules and the credit method on dividend payments

It was outlined above that the parallel application of CFC rules and other anti-avoidance measures, as well as the general application of the credit method instead of the exemption method on dividend payments can also lead to a double taxation of income. This is due to the fact that the CFC rules tax the income on a current basis whereas the credit system on dividends is only applied as soon as the CFC income is actually distributed. The fact that both measures are applicable to the same underlying income but not at the same time (as in case of a multiple application of CFC regimes) leads to a "time lack" and therefore to a possible double taxation of income.

[304] If an ordinary tax credit is possible in countries A and B.
[305] Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 202.
[306] Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 180.
[307] Borges, National Report Portugal, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, 2004, page 546.

Figure 17:



CFC taxation
income tax rate: 30%

other anti-avoidance measures /
credit method instead of exemption method
for dividends paid by the CFC
income tax rate: 35%

taxable (passive) income in year 01: 100 Euro
income tax 10% = 10 Euro
the profit of the year 01 is distributed in the year 05
dividend payment in the year 05: 90 Euro

Depending on the CFC rules of country A, the CFC income will be taxed on a current basis, i.e. most often immediately after the end of the financial year of the CFC. Under the assumption that the income determination rules are identical, the attributable income would be 100 Euro. The income tax levied in country A would be 20 Euro - after the crediting of the income tax imposed on the income of company C.[308] The overall tax burden in countries A and C is therefore 30 Euro.

If country B applies the credit method instead of the exemption method for the avoidance of double taxation caused by the dividend payment of company C in year 05, an additional income tax is levied in country B. In case the underlying income tax of country C can be credited, the tax base would be grossed up and another 25 Euro would have to be paid on the original income of 100 Euro.[309] Up to that point, the total income of 100 Euro in country C has caused a taxation of 55 Euro.[310] The problem lies in the fact that the additional 25 Euro income tax was not taken into account in country A. Both countries A and B usually only provide for a relief from double taxation with respect to the taxation in country C. Essentially, this is true for all of the Member States which apply a CFC regime and for those which follow a credit system (no matter whether it is based on a general credit system or a special regime). Even Finland and Germany - which consider, in principle, the tax burden imposed on the intermediate level in the context of an additional CFC regime - do not provide for a relief in this particular case.

The subsequent profit distribution from company B to company A will not cause any additional income tax burden if the relief provisions for subsequent dividends are equally applicable to the indirect dividend distribution (and not only to the direct dividend payment of the CFC to the resident shareholder). However, the final

[308] 30 Euro income tax (country A) ./. 10 Euro income tax (country C) = 20 Euro.
[309] 35 Euro income tax (country B) ./. 10 Euro income tax (country C) = 25 Euro.
[310] 20 Euro (country A) + 25 Euro (country B) + 10 Euro (country C) = 55 Euro. However, this is only true if the 10 Euro income tax of country C is fully credited in both countries A and B.

distribution to individual shareholders in country A will normally trigger additional income taxes. As a result, it can be concluded that the successive application of CFC taxation (country A) and the credit method on dividend payments (country B) can create a double taxation of income. Here, the main problem lies in the fact that the measures are applied on different levels by different countries and the relief provisions focus on a respective tax year. Country A should in theory provide for a - retroactive - tax credit of the additional income tax imposed in country B (in the context of the CFC taxation of country A) in order to avoid the over-taxation of the underlying income.[311] An ordinary tax credit system which solely focuses on the respective tax year cannot fulfil this requirement.

Theoretically, country A could be any European Member State with a CFC legislation since all of the jurisdictions apply their regimes to indirect shareholdings.[312] Country B could be, for example, the United Kingdom - as a regime which, in general, applies a credit system - if the requirements for application of the United Kingdom CFC regime are not fulfilled (e.g. because of one of the various exemptions). However, the intermediate country B could also be, for example, Austria or Belgium, because the latter two countries follow a concept which switches from the exemption method to the credit method for dividend income under certain circumstances. Hence, there is a variety of possible constellations which might result in a double taxation - mainly because of the parallel application of the credit method and the fact that the countries which apply the CFC rules do not (appropriately) take into account the timing difference and the additional taxation on the intermediate level.

In this regard, it is interesting to have a look at the position taken by the Italian tax authorities in 2007: an Italian company controlled a CFC in Cyprus through a 100% (intermediate) US company. Theoretically, the activities carried out by the CFC in Cyprus fulfilled the requirements for the application of the Italian CFC regime. The income of the CFC in Cyprus was subject to an income taxation of 10 percent. However, it was clear that any distribution made by the CFC to the intermediate US company would be subject to taxation in the US at a rate of 35 percent. In this situation, the Italian tax authorities granted the exemption from Italian CFC legislation on the income arising in Cyprus on the condition that, every year, the CFC company would distribute the profit realised to the US intermediate company, so that the effective tax burden applied in Cyprus and the US would be at least equal to the Italian tax rate. Finally, the Italian tax authorities asked the Italian parent company to provide, on a yearly basis, adequate documentation which proves the dividend payment and the increased taxation in the US.[313]

Clearly, the position of the Italian tax authorities avoids the double taxation of income which would be caused by the application of the Italian CFC regime and it is therefore, without any doubt, a positive approach. Nonetheless, one has to keep in mind that it is a case-by-case decision of the tax authorities and not a clear and predetermined procedure which is stipulated in the legislation. In essence, the

---

[311] As already outlined earlier, I think it is more realistic that the higher tier company (parent company) takes into account the taxation on a lower tier (subsidiary company). In theory, country B could also refrain from taxing the profit distribution according to the - for example - domestic anti-avoidance measures which switch from the exemption method to the credit method if the CFC income has already been taxed in country A (based on the CFC legislation of country A).

[312] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 43.

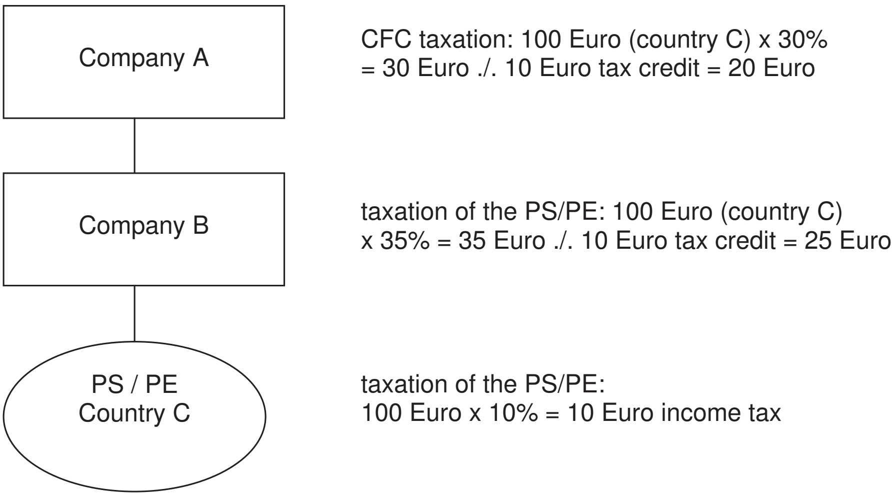
[313] See in this respect Ernst & Young, EU Tax News May / June 2007, pages 8 and 9.

approach can be seen as a kind of “exemption based on an acceptable distribution policy on a lower tier.”

e.) The application of CFC taxation to permanent establishments and partnerships

Depending on the situation, the different classification of a foreign entity - as a separate taxable entity in one country and as a transparent entity in the other country - can cause a double taxation of income. The same is true if the CFC taxation of one country is not limited to separate legal entities but also encompasses tax transparent partnerships and permanent establishments.

Figure 18:



In this example, country A applies its CFC taxation on the income of the partnership / permanent establishment (PS/PE) of company B in country C - either because of the fact that the PS is considered to be non-transparent or because of the fact that the CFC legislation of country A is also applicable to transparent partnerships and permanent establishments.

In principle, classification conflicts are a common problem of international taxation and may also arise in the interrelation of Member States in a multiple tier structure. For example, under the German or Finnish approach, general and limited partnerships are considered to be transparent entities and the taxes which are imposed on the income arise as a liability of the partners.[314] In contrast thereto, the Spanish approach classifies general and limited partnerships to be non-transparent for tax purposes and the taxes which are imposed on the income arise as a liability of the company itself.[315] Hence, if - from a Spanish perspective (country A) - the PS in

[314] OECD, The Application of the OECD Model Tax Convention to Partnerships, Annex III: List of Entities in Selected Countries (Germany, Finland), 1999.
[315] OECD, The Application of the OECD Model Tax Convention to Partnerships, Annex III: List of Entities in Selected Countries (Spain), 1999.

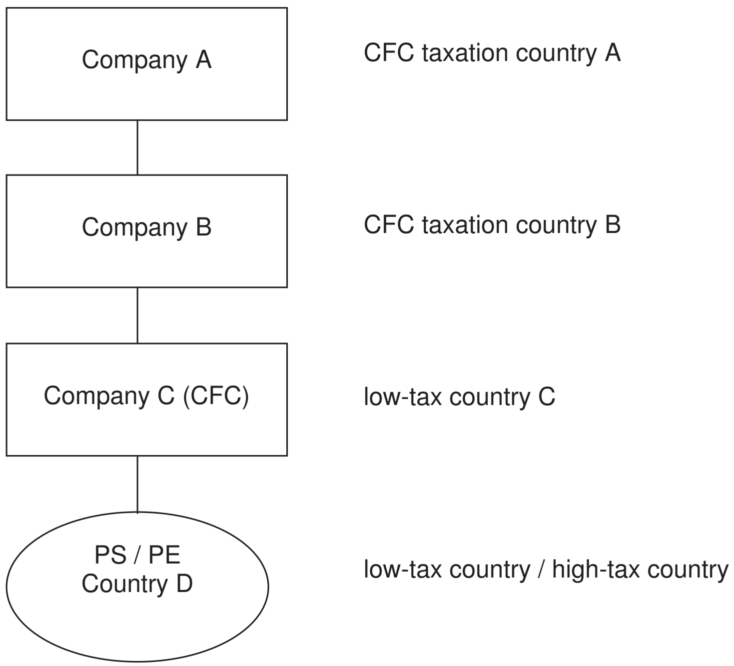
country C is classified to be a non-transparent entity (established in country C) which is subject to Spanish CFC taxation, there might be a conflict with - for example - the German perspective (country B). The reason is that Germany would tax the income derived through the transparent entity pursuant to the credit method instead of the exemption method if it is related to certain passive activities (but not according to its CFC legislation)[316] or if an activity clause is stipulated in the respective tax treaty with country C. In order to achieve an appropriate relief from double taxation, Spain (country A) would be required to provide for a tax credit of the taxes imposed in Germany (country B) on the attributed income. However, based on the earlier verifications, it seems that there is no general mechanism for such a relief in Spain.

In addition, it might be the case that the CFC regime of country A also encompasses transparent entities. This is the case, for example, in Italy. Thus, if Italy (country A) applies its CFC taxation to the income derived through the transparent partnership or the permanent establishment in country C, it might - again - result in a conflict with the German approach on the intermediate level. In other words, if the Italian system does not appropriately consider the German tax imposed on that income - and I do not see that this is the case (see above) - it will lead to a double taxation of income.

Overall, it can be summarised that the problem here lies in the fact that country A only credits the amount of taxes paid in country C and does not take into account the additional tax burden in country B. The same is true for country B: the tax credit is limited to the taxes paid in country C and the CFC taxation on a higher group level does not play any role for the tax determination. A double taxation can only be avoided - in my opinion - if country A takes into consideration the taxation in countries B and C. This should be done in the same way as described for the simultaneous CFC taxation of country A and country B (see above).

[316] Section 20 (2) of the German Foreign Income Tax Act.

Figure 19:



A variety of problems can come up where a CFC (or a company which is considered to be a CFC in one country but not in the other) has a PS/PE in a third country.[317] The overall result depends upon whether only the CFC is taken into account, only the PS/PE, or both. The different approaches and thresholds among the countries combined with the fact that there is no common way in dealing with transparent entities and permanent establishments can lead to a totally different outcome. The main problem is certainly the difference in income attribution and the treatment of the subsequent dividend payments. Again, this can lead to an insufficient crediting of taxes and therefore a double taxation of income.

f.) Double taxation caused by the determination of income pursuant to domestic rules

The different income determination rules can have the effect that the attributable CFC income is not identical in the countries which apply a CFC regime. Often, it is just a timing difference which can be due to different depreciation periods or due to the fact that one CFC regime requires the determination of income on a strict periodic approach and others allow - or require - the taxation based on the inflow and outflow of income and expenses. Many countries deviate from national accounting principles for the determination of the tax base, e.g. by allowing only pre-determined adjustments of receivables (e.g. in Portugal) or by non-accepting certain provisions for tax purposes (e.g. in Italy, in Scandinavian countries). Others are rather close to

[317] The PS/PE can be subject to a low-taxation or subject to a high-taxation.

the national accounting standards and provisions are, at least in principle, also accepted for tax purposes (e.g. in Germany). It may be the case that there is even a possibility to determine the income completely on the basis of inflow and outflow of income and expenses. In Germany, for example, it is accepted to apply the latter method for the determination of CFC income.[318] In other cases, the domestic legislation might include measures which are completely unknown or which are completely different in other countries and which can therefore theoretically lead to a permanent deviation. For example, the regular depreciation of certain intangible assets may be allowed in one country, but may be disallowed in another. Apparently, the permanent differences may create a substantial risk of double taxation. However, even the timing differences can have an overall negative impact under a strict ordinary tax credit system which solely focuses on a respective tax period.

Figure 20:

	Year 01	Year 02
Company A	CFC income 110 x 30% = 33 ./. 33 tax credit = 0 Euro	CFC income 150 x 30% = 45 ./. 38.50 tax credit = 6,5 Euro
Company B	CFC income 150 x 35% = 52.50 ./. 10 tax credit = 42.50 Euro	CFC income 110 x 35% = 38.50 ./. 10 tax credit = 28.50 Euro
Company C (CFC)	income 100 x 10% tax = 10 Euro	income 100 x 10% tax = 10 Euro

The tax base of both countries A and B is 260 Euro[319] over a period of two years. However, the allocation deviates from a timing perspective due to the different income determination rules. This has the effect that the income is not identical in year 01 and year 02 – but only the total amount of income over the period of two years. If the credit system only focuses on the respective year of income allocation instead of the period of two years, company A will not be in a position to credit the appropriate amount of income tax against its own tax burden. In theory, and taking into account an equal and simultaneous income allocation in both countries, company A could credit an overall amount of 78 Euro[320] and an exceeding amount of 13 Euro[321] cannot be utilised. In the example, company A is only in a position to credit an amount of 33 Euro in year 01 and an amount of 38.50 Euro in year 02, i.e. a total amount of 71.50 Euro. In year 02, company A would be in a position to credit much more than the

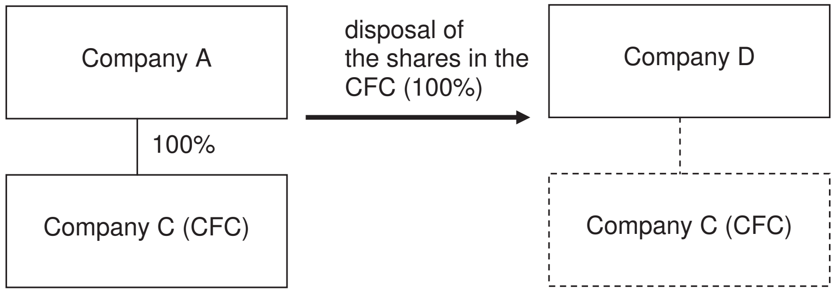
[318] Paragraph 10.3.4. of the administrative circular.
[319] 150 Euro + 110 Euro = 260 Euro.
[320] 260 Euro x 30 percent = 78 Euro.
[321] 260 Euro x 5 percent = 13 Euro. This is equal to the difference in tax rate between country A and B.

38.50 Euro but company B has a lower tax base and therefore pays less taxes than company A – even though the tax rate as such is higher. That means, even a simple shifting of income from one year to another which is based on different income calculation rules has the effect of a higher overall tax burden.

g.) Double taxation caused by the disposal of shares

The disposal of shares in a CFC can theoretically be taxable based on the general rules related to capital gains on the sale of shares or pursuant to the respective CFC legislation itself. The disposal of shares on a corporate level is typically taxable in "credit countries" like, for example, the United Kingdom. In other countries, the exemption may be linked, in principle, to a minimum holding period or a minimum percentage of shareholding (e.g. in Denmark). Hence, if the requirements for an exemption are not fulfilled, the disposal of shares will be taxable. Individual shareholders are often taxed on their income realised from the disposal of shares in a great number of Member States.[322] However, the income taxation may be dependent on the degree of shareholding, i.e. whether a substantial shareholding exists or not (and therefore whether a certain threshold is exceeded or not) and / or may be dependent on the holding period, i.e. whether the shares are sold within a certain period of time after acquisition.[323] A transfer of shares can basically lead to a double taxation of income if the taxable gain contains income elements which are at a later point in time subject to CFC taxation in the hands of the purchaser. Even though the risk of double taxation exists in both cases, the direct and the indirect disposal of shares in a CFC, the complexity in a multiple tier structure increases the likelihood of a double taxation.

<u>Figure 21:</u>



The problem can be illustrated by a simplified example: it is assumed that the only asset held by company C (CFC) is a zero coupon bond.[324] The bond was issued in year 01 and acquired by company C at a price of 100 Euro. The bond will be repaid in year 10 for 200 Euro. The shares in company C will be sold to company D in year 05. The accumulated interest amounts to 40 Euro. However, due to a decrease in the overall financial market interest rates, the fair market value of the bond is 150 Euro.

[322] See for a country overview: PricewaterhouseCoopers, Individual Taxes 2002-2003, Worldwide Summaries.
[323] This was the case, for example, in Germany (up to December 31, 2008).
[324] The example is simplified and it is assumed that the structure is not abusive.

Therefore, the sales price for the shares in company C is 150 Euro since it is totally dependent on the market price of the bond.[325]

If the CFC taxation of country A is based on a strict periodic income determination approach, the interest income will be calculated on a yearly basis, i.e. the interest income of 40 Euro is included in the tax base of shareholder A in the years 01-05. This is often not true with respect to the increase in value of the bond itself, i.e. the value which is related to the change of the market interest rates. The hidden reserves included in the bond will either be taxable as soon as the bond is sold by the CFC or will disappear over time if the bond is held until maturity. Therefore, if the shares in the CFC are sold (instead of the bond), an additional value is disclosed which was not subject to CFC taxation in country A up to that point in time. The value itself is clearly allocable to the bond and thus related to a passive activity of the CFC. The taxation of the hidden reserves of 10 Euro under the general capital gains taxation or the CFC regime of country A therefore seems to be consistent.

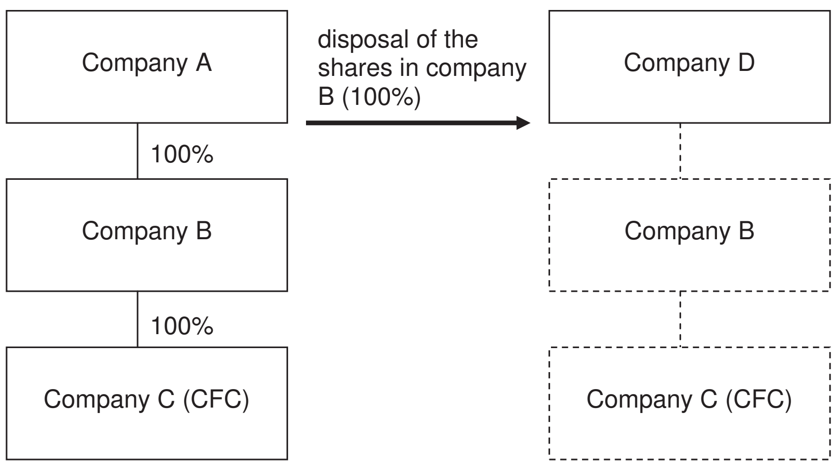
In contrast, if the CFC taxation of country A follows an approach which calculates the attributable CFC income on the basis of the inflow of income and the outflow of expenses, interest income would not be included in the CFC taxation of the years 01-05. In this case, the complete difference of 50 Euro should be subject to CFC taxation in year 05 and not only the hidden reserves of 10 Euro. Otherwise, the CFC taxation in country A would be circumvented completely.

However, the question arises whether the legislation of country D is compatible with the legislation in country A. This would only be the case if country D started to calculate the interest income for the years 05-10 on the basis of the increased value of the bond. That means, the overall CFC income attributable to the shareholder in country D for the years 05-10 should be 50 Euro and not 60 Euro. To make it very clear: this would only be based on the sales price of the shares. The balance sheet of the CFC by no means reflects that aspect.[326] The treatment of the interest income on the level of the CFC is totally unconnected to the disposal of the shares and is of no influence on this particular question of double taxation in countries A and D. Thus, a partial double taxation will only be avoided if country D provides for a reduced income allocation. However, in this case a yearly difference in the interest income remains which is not due to the different income calculation rules but which is only related to the disposal of the shares and the shifting of hidden reserves.[327] This, of course, creates a separate risk of double taxation: the overall interest income for the remaining years until maturity will be 60 Euro in country C and 50 Euro in country D. The higher tax base in country C could lead to the outcome that the effective taxation is higher than in country D and not all of the income tax can be credited against the income tax levied in country D. However, the result depends on the tax rate difference between both countries. Given the fact that country C is a low-tax country, it can be assumed that - at least in the example - the tax base difference can be compensated by the difference in the tax rate.[328] The outcome can be different in a multiple tier structure (see the example below).

[325] For reasons of simplification, leaving aside other possible aspects which can influence the value of the shares (e.g. the tax burden in state C).
[326] This would only be included in a balance sheet prepared for CFC tax purposes.
[327] The income calculated by country C is - in total - 10 Euro higher (year 05-10).
[328] However, this is only true if country D allows an ordinary credit for the income tax paid in country C on the complete income of 60 Euro - even though only 50 Euro are subject to tax in country D. Since the difference is

If the CFC income is to be calculated in country D based on the inflow of income and the outflow of expenses, the total amount of interest income will be derived in year 10 (100 Euro). It may be the case that company D is not completely free in its decision for the system of CFC income determination. This can be the case, for example, in Germany: if the German company D is not the only (German) shareholder in company C (as an alternative to the 100 percent shareholding), the German shareholders which are subject to CFC taxation are required to apply the same system of income determination, i.e. either a determination on an "as earned" basis or a determination on a periodic basis.[329] Furthermore, if company C derives - in addition to the interest income - other types of tainted income, the income determination in country D (Germany) must be made according to one system for all types of tainted income.[330] In any event, country D should provide for an income adjustment in order to avoid the double taxation of income which has already been taxed in country A. Moreover, an additional risk of double taxation exists if country C requires the income to be calculated pursuant to a strict periodic approach and the income taxes paid by country C cannot be credited against the CFC income derived by company D in year 10. However, I do not see that the Member States which apply CFC rules are prepared to appropriately consider the specific situation in the other country - at least not in a systematic manner. As already outlined earlier, mutual agreement procedures are not, in my opinion, an appropriate approach.

Figure 22:



In an alternative multiple tier scenario where the shares in the CFC are sold *indirectly* through the transfer of the shares in company B the general conclusion should be the same: A partial double taxation can only be avoided if the taxation of hidden reserves

not due to income calculation rules, the crediting of income tax related to the difference of 10 Euro is not self-evident.

[329] See paragraph 10.3.1.1. of the administrative circular. If there is no agreement, the periodic income determination will be applied.

[330] See paragraph 10.3.4.1. of the administrative circular.

is taken into account for the calculation of the subsequent attributable income in country D. However, a possible CFC legislation in country B would most certainly not take into account any shareholder changes on a higher level. That means the attributable income would not be affected by the taxation of hidden reserves in country A and a possible adjustment for CFC purposes in country D. In this case, the low-taxation in country C would be transformed into a “regular” taxation in country B. The income related to the 10 Euro hidden reserves will be taxed twice: in country A and in country B. The fact that country B allows a tax credit for the income tax paid in country C only partially reduces the negative effect.[331] I do not see that there is a single Member State - among those with CFC regimes - which provides for a systematic relief in such a scenario. The inter-relation of CFC regimes in combination with the transfer of the CFC itself seems to be too complex for existing CFC regimes to provide standard solutions.

6.10.3. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The examination of the application of CFC rules in a multiple tier structure makes one thing very obvious: the application of a system which is based on the current taxation of income cannot be structured as an “egoistic” anti-avoidance regime which ignores comparable systems applied in other countries without, at the same time, increasing the risk of double taxation of income. It was shown in previous sections that a substantial number of CFC regimes follow an unsystematic and asymmetrical (and therefore incomplete) legislative concept. If these regimes are applied simultaneously - on different tiers - without “accepting” each other (or at least without the “acceptance” on a higher tier), the likelihood of serious double taxation increases. The fact that the existing CFC regimes follow very different concepts (e.g. transactional approach vs. entity approach, different qualification of passive and base company income within the transactional / entity approach, different income determination rules, different low-taxation thresholds) and the fact that the current taxation of income is always concentrated on the total amount of (tainted) income - without any vertical separation - makes it nearly impossible to follow a neutral concept. This is self-evidently not in line with an economic principle which foremost focuses on the safeguarding of competitiveness. I think one can even conclude that the CFC regimes create a clear obstacle - just due to the fact that the legislative concept is incomplete and does not sufficiently take into account comparable concepts in other countries - to a competitive environment and an equal international level playing field. Moreover, it cannot be acceptable from the perspective of taxpayer equity that an investment through a CFC results in substantial disadvantages (or the increased risk of substantial disadvantages) which does not exist in case of comparable domestic investments or in case the foreign investment is structured differently.

It is equally clear, though, that a concept which is based on the current taxation of the basic interest component - although it merely focuses on one important income element and not all income elements - does not automatically fulfil the necessary requirement of a strict avoidance of double taxation (no matter whether it is a single

[331] For example, if the tax rate is 30% in country A, 35% in country B, and 10% in country C, the result will be as follows: the hidden reserves of 10 Euro will be taxed in country A with 3 Euro (without a tax credit - since no taxes are levied on that income at that time) and subsequently in country B with 2,5 Euro (3,5 Euro minus a tax credit of 1 Euro). The overall tax burden related to that income is therefore 6,5 Euro (65%).

tier structure or a multiple tier structure). This, of course, depends very much on the concrete concept - which will be outlined in chapter 9.

6.10.4. Conclusions Regarding Multiple Tier Structures and CFC Rules

The examples show that one of the most crucial aspects in case of CFC taxation in a multiple tier structure is the availability of an appropriate - CFC specific - tax credit. I consider an appropriate tax credit system to be a system which takes into account the peculiarities of CFC taxation - such as the current attribution of income - and therefore the creation of a "time lack" with respect to the determination of the complete and final tax burden imposed on the income. Without such a CFC specific tax credit there is an increased likelihood of a double taxation of income. Another important aspect is the fact that the CFC rules typically apply their domestic income calculation rules. This can lead to problems in case of a multiple application of CFC rules on the same CFC income, and in similar situations where the domestic tax rules play a role, e.g. where the shares in the CFC are directly or indirectly transferred to another shareholder. The CFC specific aspects can be summarised as follows:

- As a minimum requirement, the tax credit system of a country which applies a CFC taxation should give systematic relief from double taxation caused by the (additional) application of lower tier CFC rules. Thus, the higher tier CFC taxation should in general provide for an ordinary tax credit in a situation where the CFC income has already been taxed pursuant to another country's CFC regime on a lower group level.[332] Obviously, this is not self-evident since only very few countries provide for such a relief from double taxation of CFC income. In fact, only Finland and Germany treat the intermediate tax burden in the same way as the tax burden of the CFC itself, i.e. the additional income tax imposed by the lower tier CFC taxation is considered an imposition of taxes on the income of the CFC and can therefore be credited against the Finnish and German taxes imposed on the same amount of income.[333]

- The different CFC approaches can lead to income allocations which are partially overlapping but which are not identical. In such a case, a double taxation can only be avoided if the higher tier CFC taxation takes into account the lower tier CFC taxation[334] which relates to the overlapping income *and* the taxes paid by the CFC itself on the income. In theory, this requires detailed information on the lower tier CFC taxation and the applicable system - especially where a transactional approach is involved. As already outlined above, only Finland and Germany provide for such a relief if the domestic taxpayer is in a position to provide sufficient information on the respective income taxation and the taxes imposed in the other countries.

- The multiple application of CFC rules has a particularly negative effect if one of the countries (or two or more countries) which applies a CFC taxation

[332] It should be clear that the CFC regime on the lowest tier should give relief from double taxation caused by the taxation of CFC income in the low-tax country (based on what has already been outlined earlier). The simultaneous CFC taxation on a higher tier should then provide for a relief from double taxation caused by the lower tier CFC taxation (and not from the taxation in the CFC country itself).
[333] See Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, pages 66, 67.
[334] The taxes imposed by the lower tier CFC taxation can, of course, already be reduced by the taxes imposed on the income in the country of the CFC.

suffers tax losses or if a tax loss carry forward is available. The current taxation of CFC income in combination with the inability of a tax credit in the respective year - due to the non-existence of a domestic income tax - increases the overall tax burden considerably. The reduction of the domestic tax loss carry forward through the current attribution of CFC income does not allow the use of the tax losses in subsequent years. In contrast to a situation where only one CFC regime is involved, the multiple application of two (or more) regimes has the effect that the tax rate is increased to a "regular level" and - in addition - the domestic tax losses are offset against the attributed CFC income. The situation can therefore not really be compared to a regular dividend payment where a shareholder with a controlling interest can influence the decision whether and in which period a distribution takes place. In such a situation, the distribution could be postponed to a point in time where the shareholder pays domestic income tax and is therefore in a position to credit the foreign income tax. This is not possible in case of CFC taxation where the income is currently attributed to the shareholder. However, it cannot be directly compared to the treatment of a permanent establishment, either. Even if the double taxation is avoided by the application of the credit method instead of the exemption method, it must be taken into account that only one legal entity is involved and not two (or more) completely separate legal entities as in case of CFC taxation. It is quite clear that a "regular" ordinary tax credit cannot provide for a relief from double taxation in such a tax loss scenario. Finland and Germany, the only Member States which provide for a systematic relief in case of multiple CFC taxation, do not provide - at the same time - for a possibility of a roll-over (or a similar system) to solve the problem of double taxation caused by tax losses. On the other hand, countries which provide for a roll-over in their domestic tax system - like Portugal - do not solve the problem of multiple CFC taxation. Hence, it must be concluded that none of the Member States with CFC taxation really systematically solves the problem of double taxation in the aforementioned situation.

- The tax losses suffered in the CFC country itself can lead to a double taxation of income, too. In my opinion, the main problem in this case is the tax loss carry forward limitation in the countries which apply the CFC taxation and in the CFC country. The more countries are involved, the higher the possibility that there are countries involved with a tax loss carry forward limitation. The country with the shortest tax loss carry forward period influences the overall taxation of the group. This can have the effect that the (unlimited) tax loss carry forward in the other countries does not play any role at all, e.g. in a situation where the tax loss carry forward expires in the country with the highest tax rate. There is an increased probability that the positive CFC income is taxed before the tax loss carry forward is actually utilised. There are a number of Member States which have a (general) tax loss carry forward limitation, like Estonia, Finland, Italy, Portugal and Spain. In some Member States, the possibility of a carry forward of negative CFC income is more restricted than the regular domestic tax loss carry forward. For example, the Finnish CFC rules provide for a five year carry forward of negative CFC income whereas the regular domestic tax loss carry forward is 10 years. In Portugal, the negative CFC income cannot be carried forward at all.

- The application of CFC rules and other anti-avoidance measures within the same group structure as well as the general application of the credit method instead of the exemption method on dividend payments can also lead to a double taxation of income. Again, the problem lies in the fact that the methods are not applied in the same tax period. The CFC rules tax the income on a current basis whereas the credit method is applied on dividends (on a lower level - not on the level of the country which applies the CFC rules) as soon as the dividends are actually distributed. This leads to the result that an additional tax is imposed at a later point in time on a lower group level which was not taken into account at the moment where the CFC income was attributed and taxed. An ordinary tax credit system which focuses on the respective tax period cannot provide for relief from double taxation in such a situation. I do not see that any of the existing European CFC regimes properly deals with such situations.

- The fact that classification conflicts can exist in multiple tier structures and that some CFC rules are limited to separate legal entities but others also encompass transparent partnerships and permanent establishments (PS/PE) - like in Italy - can, of course, create additional problems. In my opinion, this can only be avoided by a tax credit system which takes into account the PS/PE taxation on a lower level pursuant to the same principles as described for the multiple CFC taxation in two or more countries.

- The focus on domestic income determination rules is another important factor. It is obvious that the lack of co-ordination and harmonisation among the CFC countries can lead to deviations with respect to the CFC income calculation and with respect to the direct or indirect transfer of shares in the CFC from one country to another. In these cases, it seems to be nearly impossible to provide for a systematic relief from double taxation. Apparently, these problems exist in all of the Member States which apply CFC rules.

Thus, the application of CFC rules in multiple tier structures can create problems which may only partially be solved by - for example - an extended ordinary tax credit system which does not solely focus on a single tax period. Other double taxation issues, especially those related to the strict domestic approach, may only be solved by mutual agreement procedures among the countries involved.

The principles derived from chapters 2 and 3 support a limited taxation according to the principle of capital export neutrality under certain circumstances. Such taxation, however, should be restricted to the basic interest component included in the CFC income and should by no means encompass the total amount of CFC income. In any event, the current taxation of income - no matter whether it is the taxation under a CFC regime or the taxation under an alternative regime - must not result in any over-taxation and penalisation. The same is true, of course, for the application of such regimes in a multiple tier structure: any regime which taxes income on a current basis should provide for a consistent relief from double taxation which is caused by the multiple taxation of income on different group levels.

6.11. Conclusions

1.) The countries which apply a transactional approach have a similar understanding of what is to be considered “passive” income in the context of CFC taxation, e.g. rental and leasing income, interest income, and royalty income. The common features of these passive activities are, amongst others, the fact that the income which is related to these activities is, at least to a large extent, not taxed in the state in which it is produced - as it would be required by the economic principle of capital import neutrality - but in the state of residence of the CFC. This is due to the allocation of taxing rights stipulated in the double tax conventions which follow the pattern of the OECD-MTC. Moreover, the activities are usually capital intensive activities. The portion of income which is related to the interest element is therefore increased. The concept of the transactional countries is the targeting of a direct tax base erosion (e.g. in Spain) and sometimes even the indirect tax base erosion (e.g. in Denmark, Germany).

2.) The rules related to base company activities are partly different. Here, the *circumstances* for the provision of the services are decisive and not the *type* of services. That means, even non-capital intensive activities are subject to CFC taxation if - for example - the services are provided towards the resident shareholder or with the involvement of the resident shareholder. However, the economic result of the supply of non-capital intensive services may consist to a large extent of income which is related to the economic output created by personnel and not, as is the case for capital intensive services of the aforementioned types, of income which is largely related to the investment of capital, i.e. interest components, amortisation of the investment and the risk related to the investment. In principle, this is equally true for Germany, Spain and Lithuania. The Danish approach is a bit different from the other transactional countries since it is strongly connected to financial income without having separate base company rules.

3.) The entity approach goes even further and covers not only the situations which lead to tainted income and base company income under a transactional approach, but also covers the income related to an active business which is exercised by the CFC as a minor activity (“all-or-nothing” approach). An activity-based exemption from CFC taxation typically requires that the foreign company carries on mainly an industrial or commercial activity *and* mainly on the local market. Of course, this excludes most of the inter-company services which are normally directed towards the country of the shareholder and the countries in which other group companies are established. The entity approach is therefore - similar to the base company activities - completely unconnected to the question of capital intensive or non-capital intensive services. The entity approach is the predominant system of CFC taxation and all of the countries which follow an entity approach have - in one way or another - such a link to the activity of the foreign entity.

4.) The requirement of low-taxation is a common feature in *all* of the European countries with a CFC regime - no matter whether they follow a transactional or an entity approach. From the perspective of these countries, the current taxation of CFC income seems to be necessary only in cases where the effective foreign tax rate is below a certain threshold and the income is therefore considered to be low-taxed. If the income is subject to a taxation which is comparable to the domestic taxation or even higher than the domestic taxation, an immediate income allocation to the resident shareholder will not take place. Furthermore, it is important to note that the determination of the effective foreign tax rate is usually based on a taxable income which is adjusted according to the domestic tax rules. Overall, the low-tax requirement ranges from less than 1/1 of the domestic corporate income tax rate (like in Germany) to less than 1/2 of the domestic corporate income tax which would theoretically be applied on that income (like in France). The remaining countries are in-between these two fractions.

5.) Another basic requirement for the application of CFC rules is the ownership in the CFC: in order to attribute the CFC income to a resident taxpayer, a certain - direct or indirect - shareholding is required. It is important to recognise that “control” in the sense that a resident shareholder or a group of related shareholders own *more* than 50 percent in the CFC is in most cases not required. A strict “more than 50 percent” requirement exists in Lithuania, where the resident entity (or individual) together with *related* parties has to hold - directly or indirectly - more than 50 percent. That means, in nearly all of the countries there is either a lower threshold or other - alternative - criteria exist which can trigger the application of the CFC rules. The examination of the ownership requirements in the countries shows that often not even a “substantial” or “qualified” shareholding is required, either. The requirement of control often refers to a certain (minimum) percentage of related or *unrelated* resident shareholders. Hence, if a substantial percentage is held by totally unrelated resident shareholders, the minimum threshold for the individual shareholder is extremely low, e.g. 5 percent in France if 50 percent of the share capital of the foreign company is directly or indirectly held by French residents, or 10 percent in Finland if at least 50 percent are held by Finnish residents. A drastic example in this respect is Germany: if the CFC exclusively or almost exclusively derives gross revenues of a capital investment kind, the tainted income will be allocated to the resident shareholder without applying any minimum threshold. This gives the impression that the influence of the shareholder is in fact secondary, and the main focus is on the current taxation of CFC income as an anti-deferral measure in order to avoid any tax base erosion instead of a clear limitation of the CFC regimes to majority shareholdings.

6.) The domestic concepts of income attribution range from a deemed dividend approach (e.g. in Germany) and a look-through (or “piercing the veil”) approach (e.g. in Estonia, Italy, Portugal, the United Kingdom and Sweden) to a re-valuation of the shares in the CFC (the latter system exists in the Netherlands which, however, does not have a CFC regime in the narrower sense). Some Member States have a regime which might be seen as a look-through approach, but which is not completely clear in this respect (e.g. in Denmark and Spain). However, none of these concepts is fully convincing since the attributed income by no means reflects the result based on the commercial accounts of the CFC. This is due to the different CFC approaches (transactional approach and entity approach) and the fact that the attributable income is in most cases calculated pursuant to the domestic rules of the country which applies its CFC taxation. In fact, the income attribution according to the transactional approach can rather be seen as a system which solely and directly focuses on the separate income elements derived by the CFC from the perspective of the state of residence of the shareholder but - at the same time - completely ignores the income determination of the foreign legal entity. In contrast, the entity approach takes into account all income elements (active and passive) or none of the income elements, depending upon whether the active or the passive activity prevails. However, even the entity approach does not reflect the actual income based on the commercial accounts of the CFC but only the income which is based on the income determination rules of the state of residence of the shareholder.

7.) The taxation based on the income attribution according to CFC rules and the taxation of subsequent dividends and subsequent disposal of shares can lead - at least partly - to a double taxation of income. It is therefore necessary for the CFC regimes to provide for some sort of relief from double taxation in these cases. This can be done by way of an adjustment of the tax base or a tax credit of the income tax levied on the former CFC income attribution against the taxes imposed on the dividend payments and the capital gains. Interestingly, the relief from double taxation caused by a subsequent dividend payment is provided by all of the regimes in one way or another (usually by adjustment of the tax base - with the exception of the United Kingdom which provides for a tax credit). In contrast thereto, the relief from double taxation caused by the disposal of the shares in the CFC is only granted in very few countries, namely in Denmark, Germany, Spain and the United Kingdom. It is quite apparent that there is no justification for a different treatment of dividends and capital gains since both transactions contain, in principle, the same profit elements and both transactions can lead to a double taxation of income. In addition, the test to the principles derived from previous chapters shows that - in order to avoid any penalty effects for the investor - the relief from double taxation cannot be restricted by CFC specific time limits - like in Finland and Germany - which can make the elimination of double taxation considerably more difficult or even impossible (e.g. in case of tax losses). Moreover, a double taxation of income can be caused by withholding taxes levied on the subsequent dividends. In this case, the withholding taxes should - retroactively - be credited against the income taxes imposed on the attributed CFC income if the actual dividend payment is exempt from taxation. Similar problems can arise if a double taxation of income is avoided by a tax credit of the former CFC income tax burden against the subsequent dividend income tax burden. Here, the problem lies in the fact that an ordinary tax credit system will often not provide for sufficient relief from double taxation (this can be true for income taxes and withholding taxes).

8.) The treatment of losses in the context of CFC taxation is - in my opinion - inconsistent and asymmetric and goes much further than is really necessary from an anti-avoidance point of view. One of the main aspects is the fact that positive CFC income is treated differently from negative CFC income. Often, the positive CFC income is taxed by the residence state of the shareholder in the same manner as domestic income derived by the shareholder. In contrast, negative CFC income can usually not be offset with positive domestic income of the shareholder but can only be carried forward and offset with positive CFC income of the same foreign legal entity in subsequent periods. It seems the latter is true for all of the European CFC regimes outlined in this chapter. In other words, the utilisation of negative CFC income is extremely restricted. However, the reverse situation is equally problematic, i.e. if positive CFC income is attributed to the resident shareholder who suffers domestic tax losses or has a domestic tax loss carry forward available. The examination revealed several problematic aspects, especially where the CFC regimes apply specific time limits for subsequent dividend payments and the disposal of shares, and time limits for the carry forward of negative domestic income and (or) negative CFC income. From my perspective, there is not a single European CFC regime which provides for an acceptable treatment of negative CFC income. It shows clearly, in my opinion, that the Member States which apply CFC rules are obviously willing to give away a symmetric concept of (international) taxation of income in favour of a strict domestic anti-deferral policy. The price for such an approach is the violation of basic freedoms - which will be outlined later on in more detail. An alternative concept which does not provide for an unequal treatment of domestic and international income is therefore absolutely necessary. In chapter 9 I will outline an alternative - symmetric - concept which is, in my opinion, in line with the basic freedoms of the TFEU, which is supported by the economic principle of capital import neutrality, but which - at the same time - accepts the necessity of an anti-deferral regime for part of the income.

9.) The examination shows that the CFC regimes have to provide for the crediting of taxes imposed on the underlying CFC income. However, an appropriate relief from double taxation requires that the crediting does not only encompass the corporate income tax in the CFC country but also any other income tax levied in third countries (e.g. in case of a permanent establishment) and the withholding taxes deducted from the respective income elements, e.g. royalty income, interest income. The deduction of taxes as a kind of business expenses is not sufficient and leads to a partial double taxation of income. The possibility for a crediting of the income taxes imposed in the CFC country exists in almost all of the Member States which apply such regimes. An exception, for example, is Hungary where no such indirect tax credit exists. The crediting of taxes imposed in third countries is provided for by a number of countries, e.g. Denmark, Finland, Germany, Italy, Spain, Sweden and the United Kingdom.

10.) Another very important aspect is the fact that CFC regimes most often do not sufficiently provide for the multiple application of CFC taxation and similar anti-avoidance rules, i.e. in situations where comparable legislation is applicable on a lower group level. The examination shows various problems which can arise in such a situation. One of the main aspects is certainly the question of an appropriate tax credit system. In order to solve the double taxation conflicts caused by the current taxation of income the regime must provide for a tax credit system which takes into account the taxation on a lower group level and which does not strictly focus on a particular taxation period. That means, taxes imposed on the underlying income at a later point in time on a lower group level cannot be outside of the scope of the tax credit system. Otherwise, and this is very often the case, the CFC regime leads to an immense over-taxation of income. Moreover, substantial conflicts can arise, *inter alia*, in cases where tax losses are involved, where limitations exist with respect to tax losses and time limits for subsequent profit distributions and capital gains, where the income is determined pursuant to the domestic tax rules of the country which applies the CFC taxation, where the income is taxed on a intermediate level according to the credit method, and in case of classification conflicts. Thus, the application of CFC rules in a multiple tier structure can create problems which may only partially be solved by - for example - an extended ordinary credit system. Other double taxation conflicts may only be solved by mutual agreement procedures among the countries involved. In other words, the multiple tier structures can considerably increase the already existing double taxation conflicts caused by the application of CFC rules. Currently, only Finland and Germany provide for a systematic (ordinary) crediting of the taxes imposed according to a lower tier CFC taxation. Other regimes either ignore these types of double taxation, rely on mutual agreement procedures (like in France), or take the additional (higher) taxation into account for the question of a motive exemption (like in the United Kingdom). However, the problem is that even the two countries which have a system in place for dealing with such a multiple CFC taxation do not provide for more than the simple ordinary tax crediting. That means

Finland and Germany do not really solve the other problems which may come in a multiple tier structure and which were revealed in this chapter.

11.) Mutual agreement procedures as well as any other solutions which are not based on a clear legislative and systematic concept are not, in my opinion, the appropriate way of solving the problem of double taxation of income in the context of CFC taxation. As already outlined above, what is required is an alternative concept to CFC rules which provides for a consistent taxation of domestic and foreign income. In my opinion, this can be achieved by a system which accepts the taxation of income in the state in which it is produced - and which therefore, in general, follows the principle of capital import neutrality - but without ignoring the necessity of an anti-deferral taxation for part of the income under certain circumstances.

12.) An alternative concept should follow the principles outlined in previous chapters by providing a systematic and symmetrical system of current taxation, i.e. a system which is safeguarding competitiveness without creating any penalty effects for an investor. In essence, this would result in a deviation from the typical CFC regime towards a regime which limits the current taxation of income to the basic interest component and which therefore provides for a horizontal and vertical separation of income (instead of a merely horizontal separation of income). In any event, the economic principles and equity aspects derived from chapters 2 and 3 clearly support, in my opinion, such a limited taxation according to the principle of capital export neutrality. However, neither a CFC regime nor an alternative approach should lead to an over-taxation of income and, therefore, have to provide for a consistent relief from any sort of double taxation caused by the current taxation of income. An alternative system will be presented in chapter 9.

7. CFC Legislation and Double Tax Conventions

7.1. Introduction

The significance of CFC legislation as an anti-deferral measure applied by an increasing number of high-tax countries raises the question of its compatibility with an existing tax treaty and the type of income in the context of such a tax treaty. Thus, it is important to clarify whether CFC rules have to be specifically preserved in double tax conventions in order to be applicable and, in addition, to clarify the type of income in the light of double tax conventions. The questions are of particular importance since - as already outlined in the foregoing chapters - CFC rules are by no means restricted to tax havens but are in most cases equally applicable to tax treaty countries which simply have a lower tax rate than the country which applies its CFC legislation. In the European Member States only little case law exists which is related to these questions, and the outcome of the cases is quite different. In the following, I will outline the *A Oyj Abp* Case (Finland), the *Schneider* Case (France), the *Bricom Holdings* Case (the United Kingdom), and the *Captive Insurance* Cases (Sweden). Moreover, I will make a brief excursion to non-European decisions by describing a Brazilian case and a Japanese case. All of these cases are interesting and important in this context. However, in order to understand the outcome of the cases and to find an answer to the question of compatibility with tax treaties, the position of the OECD - which is stipulated in the OECD Commentary - will be verified. Furthermore, in order to clarify the type of income in the light of the OECD-MTC it is of particular relevance to have a closer look at Articles 6, 7, 10, 11, 12, 13 and 21 of the OECD-MTC.[1] The verifications themselves will be concentrated on the aforementioned case law and the OECD-MTC but will not be extended to other (model) tax conventions. The outcome of the following sections will be tested step-by-step with regard to the important principles derived from chapters 2 and 3. The test will not encompass EU law, because this will be tested exclusively in chapter 8.[2]

7.2. Case Law Related to CFC Legislation and Double Tax Conventions

7.2.1. The *A Oyj Abp* Case (Finland)

A Oyj Abp (A) is the parent company of a Finnish-based group of companies with a wholly owned subsidiary – A Finance NV – incorporated in Belgium.[3] The operations of A Finance NV comprise, amongst others, activities in the fields of research and

---

[1] The Articles will not be discussed in the respective order (Article 6 of the OECD-MTC will be discussed after Articles 7, 10, 11 and 12 of the OECD-MTC).

[2] There are also references which are covered by chapter 5, e.g. the ability-to-pay principle (see in this respect section 7.7).

[3] A Oyj Abp Case, Supreme Administrative Court, KHO 2002/596 (26), dated March 20, 2002, International Tax Law Reports (ITLR), Volume 4, 2002, page 1043 et seq.; See with respect to the A Oyj Abp Case also Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq.; Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Rytöhonka, Belgian coordination centre deemed by Finnish Court to be a CFC, Tax News Service, July 11, 2002; Pahapill, Finnish CFC Regime Not a Threat, Officials Say, Tax Notes International 2003, page 1015 et seq.; Helminen in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, page 204 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 126; Brähler, Controlled Foreign Companies-Rules, 2007, page 62; Malherbe et al., Controlled Foreign Corporations in the EU After *Cadbury Schweppes*, Tax Management International Journal 2007, page 607 et seq. See with respect to the question of the consistency of CFC legislation and (Finnish) tax treaties, in general, also the FEE Position Paper on Controlled Foreign Company Legislations in the EU, European Federation of Accountants, April 2002, pages 12, 13.

development, information technology, accounting and providing the European subsidiaries of A with financial services. A Finance NV is what is known as a co-ordination centre and since the beginning of 1999 it probably falls within the definition of the Finnish CFC legislation due to the preferential tax treatment provided for by the Belgian legislation.[4] The corporate tax calculated according to Finnish tax rules is less than 16.8 percent.[5] A applied for an advance ruling on whether, as a Finnish resident shareholder of A Finance NV, it may be taxed in Finland on the basis of the CFC Act, when the tax treaty between Finland and Belgium and the provisions of the EC Treaty are also taken into account.[6] The Central Board of Taxation issued an advance ruling for the years 1999 and 2000 according to which A may be taxed in Finland on the basis of the CFC Act.[7] The Board did not see any conflict with the tax treaty since the CFC rules are considered to be part of the basic domestic rules set by national law for the purpose of determining which facts give rise to a tax liability and these rules are not addressed in tax treaties. The Belgian subsidiary is not taxed in Finland but the Finnish resident company A and this does not conflict with the purpose or wording of the tax treaty. The tax treaties concluded by Finland do not contain any unconditional obligation for the removal of economic double taxation. Furthermore, pursuant to the Board, the provisions of the EC Treaty are of no relevance to this case.[8]

The dissenting members of the Board took the position that the *lex specialis* nature of the tax treaty must be taken into consideration. Any incompatibility between the tax treaty and the CFC Act must be remedied by giving primacy to the tax treaty provisions. The tax would be levied on the basis of income accruing from a Belgian source, even though that income is not connected with Finland.[9] The tax liability would effectively be based on the income of A Finance NV and this is contrary to the Finnish system of tax law since in Finland a shareholder is not liable to tax on the income of its subsidiary, except in the case of a dividend distribution. Furthermore, the taxation would also be contrary to the provisions on the taxation of business income in Article 7 of the Finland-Belgium tax treaty because the income of the subsidiary is made subject to tax in Finland, even though the company has no permanent establishment in Finland.[10]

A appealed to the Supreme Administrative Court and requested that the advance ruling of the Central Board of Taxation be overturned. In a letter from the Belgian Ministry of Finance, attached to the appeal, the application of the CFC Act is described as a breach of the Finland-Belgium tax treaty and that it is contrary to EC law. By applying the CFC legislation Finland is the recipient beneficiary of the tax revenue based on the profits of the foreign company. It is further noted that Article 10

[4] A multinational enterprise may incorporate a co-ordination centre in Belgium if it meets the conditions provided for by the relevant legislation. Pursuant to the legislation in 1999, a co-ordination centre must employ at least 10 people within two years of the commencement of its operations. Certain kinds of services may only be provided to other group companies. The statutory general corporate tax rate applies to a notional tax base determined according to a mark-up percentage of their operating costs other than personnel and financial costs. In case of A Finance NV the mark-up was 8 percent. In addition, co-ordination centres are liable to an annual tax which is calculated per employee with a certain maximum amount.
[5] 3/5 of the 1999 Finnish corporate tax rate of 28 percent.
[6] International Tax Law Reports (ITLR), Volume 4, 2002, page 1044.
[7] ITLR, Volume 4, 2002, page 1045.
[8] ITLR, Volume 4, 2002, page 1046.
[9] The financing of the activities of subsidiaries in Finland is provided from Finland and not from Belgium.
[10] ITLR, Volume 4, 2002, pages 1046, 1047.

(5) of the OECD-MTC should prevent Finland from taxing the undistributed profits of the subsidiary in Belgium. Finland treats the co-ordination centre factually as a permanent establishment of A, which is prohibited by Article 5 (7) of the OECD-MTC. The Belgian Ministry of Finance stated further that the application of a CFC legislation must be explicitly permitted in the tax treaty between both countries and this is not the case in the underlying tax treaty. Apart from that, the CFC legislation is incompatible with the freedom of establishment.[11]

The Supreme Administrative Court verified first the preparatory legal drafts of the Government Bills on controlled foreign company legislation.[12] According to the Government Bills, the objective of the CFC Act is to prevent the avoidance of Finnish taxation by the use of controlled foreign companies. The Court stated that the income derived from a CFC can be characterised in two different ways. The income may be characterised according to the legislation of the country in which the CFC is situated and included in the income of its shareholder in the shareholder's country of residence, but not treated as an actual distribution of profit, or it may be characterised as income of the shareholder company which was received on the basis of its shareholder status as a profit distribution from the CFC. The Finnish CFC Act does not explicitly provide any definition of the character of income. It could be business income, dividend income or other income. Pursuant to Finnish legislation, the attributed CFC income is not defined as profit distribution. It is therefore not obvious that CFC income should be characterised as dividend income and its type must be determined on a case by case basis according to the circumstances and the activities of the CFC and its parent company. In the underlying case, the type of activity carried out by A Finance NV, its significance to A and Article 1 of the Business Income Tax Act are taken into consideration. Pursuant to the Court, the income received by A from the Belgian subsidiary is not dividend income but other business income. Business income of that kind is to be classified as passive income and base company income.[13]

In the following, the Court made general explanations on tax treaties. As a rule, tax treaty provisions, as *lex specialis*, overrule any conflicting rule of national law. According to the Vienna Convention on the Law of Treaties, a contracting state may not, in its national legislation, unilaterally alter an international convention that it concluded. Accordingly, not even national CFC legislation may be used to alter the content of a tax treaty which has already been concluded. Tax treaties are concerned with juridical double taxation and are not generally concerned with economic double taxation, unless it is otherwise provided in a tax treaty. The Finland-Belgium tax treaty does not contain provisions on the removal of economic double taxation.[14] The tax treaty was concluded[15] before the Finnish CFC legislation entered into force[16] and is drafted along the general lines of the OECD Model Tax Convention. The Finland-Belgium tax treaty does not make any specific reference to CFC legislation.[17] The Commentary to the OECD Model Tax Convention was supplemented with a

[11] ITLR, Volume 4, 2002, pages 1048, 1049.
[12] Government Bill number 155/1994 and number 149/1998 which formed the amendment to the CFC Act adopted on December 23, 1998.
[13] ITLR, Volume 4, 2002, pages 1062, 1063.
[14] ITLR, Volume 4, 2002, page 1064.
[15] Concluded on June 18, 1976 and supplemented on March 13, 1991.
[16] Adopted on December 16, 1994 and entered into force on January 1, 1995.
[17] ITLR, Volume 4, 2002, page 1066. The same is true for the other tax treaties concluded by Finland (see Belgian co-ordination centre deemed by Finnish Court to be a CFC, Tax News Service, July 11, 2002).

paragraph concerning CFC legislation in 1992. However, the amendments to the Commentary were based on a study of the OECD published in 1987 which dealt with CFC legislation within the OECD.[18] The Court held that the applicability of CFC legislation is not restricted in situations where the relevant tax treaty does not contain a provision explicitly permitting the application of such legislation. This applies particularly to tax treaties which were concluded before national CFC legislation was adopted in the tax system of the relevant contracting state.[19]

For the purpose of applying the Finland-Belgium tax treaty the income is to be considered business income and not dividend income according to the aforementioned characterisation. This is due to the fact that the tax treaty itself does not contain any definition of business income and therefore a definition is derived from national law.[20] According to Article 7 (1) of the tax treaty between Finland and Belgium, the profits of an enterprise of a contracting state shall be taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. If this is the case, the profits of the enterprise may be taxed in the other contracting state but only so much of them as are attributable to that permanent establishment. Article 5 (1) of the tax treaty between Finland and Belgium defines a permanent establishment as a fixed place of business through which the business of an enterprise is wholly or partly carried on. However, there is agreement that there is no permanent establishment of the Belgian subsidiary in Finland.[21]

The question remains whether Article 7 (1) of the tax treaty between Finland and Belgium prevents the taxation of A under the Finnish CFC Act. In this respect, the Finnish Supreme Administrative Court strongly focused on paragraphs 22 to 26 of the Commentary on Article 1 of the OECD-MTC. I will go into detail of these paragraphs below. The application of CFC legislation falls within the category of counteracting measures referred to in paragraph 25 and paragraph 7 of the Commentary. However, the extension of counteracting measures to active business would be – according to paragraph 26 – contrary to the spirit and the principles underlying the OECD-MTC.[22] Pursuant to the Court, the fact that the quoted paragraphs – especially paragraph 26 – was only later introduced[23] into the Commentary does not prevent the use of the Commentary as an auxiliary source of interpretation. The taxation in the hands of two different taxable persons is not in general contrary to the tax treaty since tax treaties are basically concerned with juridical double taxation and not with economic double taxation. Paragraph 23 of the Commentary to Article 1 may, in itself, be concerned with economic double taxation. As it is noted in the Commentary that the large majority of the member countries is of the opinion that the application of CFC does not conflict with the articles of a tax treaty, one may reach the conclusion that the Finnish CFC Act is similar to the CFC legislation of other OECD countries. The Court concluded that according to the Commentary to the Model Tax Convention, and taking paragraph 7 of the Commentary to Article 1 into consideration, a tax treaty that is based on the OECD-MTC (as it is the case for the Finland-Belgium tax treaty) must admit the possibility of using CFC legislation, save where that tax treaty contains

[18] OECD, Double Taxation Conventions and the Use of Base Companies (1987).
[19] ITLR, Volume 4, 2002, page 1067.
[20] ITLR, Volume 4, 2002, page 1068.
[21] ITLR, Volume 4, 2002, pages 1068, 1069.
[22] ITLR, Volume 4, 2002, page 1070.
[23] In 1992.

provisions to the contrary. Article 7 (1) of the Finland-Belgium tax treaty does therefore not prevent the taxation of A under the Finnish CFC Act.[24] Finland taxes the shareholder situated in Finland on income derived from a CFC, not the company situated in a tax treaty country. Finland is entitled to do so on the basis of its own national law and the provisions of the tax treaty between Finland and Belgium do not prevent such taxation. This does not amount to juridical double taxation. From the standpoint of Finnish taxation, double taxation does not arise because the tax on the CFC income does not exceed the amount which would have been collected if the CFC had not been established and its activities had been carried out in Finland or through a branch situated abroad. This ensures capital export neutrality from the perspective of domestic taxation.[25]

From my perspective, the Finnish Supreme Administrative Court deals, in general, with all of the aspects which are of importance for the question whether the CFC regime is in line with the Finland-Belgium tax treaty or not.[26] The most significant conclusion is, in my opinion, the fact that the Court confirmed that the income calculated pursuant to the CFC regime in Finland is not identical to the income derived by the subsidiary company in Belgium and, therefore, the income attribution does not lead to a juridical double taxation, but merely to an economic double taxation of income. The latter, however, is not within the scope of the tax treaty - I will come back to that aspect again later on. Moreover, it is also interesting to see that - for tax treaty purposes - the Court classified the attributable income, with reference to Finnish domestic legislation, as business income and not as dividend income. In principle, I fully agree with the classification as business income,[27] but the method of classifying the income is, in my opinion, not completely made clear by the decision. It remains open whether the attributable income is to be classified as business income in general or only under certain circumstances. Pursuant to Helminen, the wording of the Supreme Administrative Court was selected very carefully and it may leave room for situations where it may have to be concluded that the application of the Finnish CFC regime is contrary to a tax treaty.[28] Moreover, it is, in my opinion, highly questionable whether the decision can be based on amendments to the OECD-Commentary which were made after the conclusion of the Finland-Belgium tax treaty.[29] I will go into more detail of the latter aspects - and my position in this respect - later on.

[24] ITLR, Volume 4, 2002, pages 1071, 1072.

[25] ITLR, Volume 4, 2002, page 1073.

[26] See with respect to the A Oyj Abp Case (and the criticism) also Helminen in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, page 204 et seq.

[27] In contrast to Helminen (see above) who took the position that the classification of the attributable income as dividend income or other income instead of business profits would have been more appropriate (Helminen, page 212). However, see in this respect the different positions of Aigner and Lang. Both take the position that the income is to be classified as dividend income instead of business income. *"Die Anwendung des Art 7 OECD-MA auf die dem Gesellschafter hinzugerechneten Einkünfte vermag aber (…) im Anwendungsbereich des Art 10 OECD-MA für Dividenden nicht zu überzeugen*" (Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 126; see also Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International, 2002, page 407 et seq. (413, 414)). *"Meines Erachtens zeigt die Analyse der in Betracht kommenden Abkommensvorschriften, dass die besten Argumente für die Anwendung der Art. 10 OECD-MA sprechen, wonach die Staaten, die das CFC-Regime anwenden, als Ansässigkeitsstaaten auch das Besteuerungsrecht haben"* (Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (721)).

[28] Helminen in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, page 207.

[29] See in this respect also Lang who considers the outcome of the case to be more convincing than the reasoning. The reference to the OECD-Commentary is, according to Lang, "doubtful" (see Lang, CFC-Regelungen und

7.2.2. The *Schneider* Case (France)

Schneider Electric, a French corporation, was a 100 percent shareholder of *Paramer*, a Swiss corporation established in the canton of Geneva.[30] The Swiss corporation

Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (723) and Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.).

[30] *Schneider* Case, Conseil d'Etat (French Supreme Tax Court), dated June 28, 2002; ITLR, Volume 4, 2002, page 1077 et seq.; see with respect to the *Schneider* Case also Mbwa-Mboma, Treaty with Switzerland Overrides French CFC Legislation, French High Tax Court Confirms, Tax Analysts Tax Document Service 2002, Doc. 2002-15647; Lessambo, French CFC Legislation: The End of a Legislatively Controversial Rule, Tax Planning International Financing 2002; Donsimoni, Schneider Case Clarifies Application of Tax Treaties to French Companies, Tax Analysts Tax Document Service 2002, Doc. 2002-18637; Richter, Conseil d'Etat bestätigt Vorrang des DBA-Rechts von nationaler Hinzurechnungsbesteuerung, Internationales Steuerrecht 2002, page 653 et seq.; Bérengier, French Administrative Supreme Court Holds that Tax Treaties Override French CFC Rules, Tax Planning International Review 2002, page 3 et seq.; Not, French CFC Rules Held Incompatible with OECD Model Tax Convention, Tax Planning International Review 2002, page 3 et seq.; Douvier / Bouzoraa, Court of Appeals Confirms Incompatibility of CFC Rules with Tax Treaties, European Taxation 2001, page 184 et seq.; Richter, Neueste Entwicklungen der französischen Rechtsprechung zum Außensteuerrecht bei DBA-Staaten, Internationales Steuerrecht 2002, page 231 et seq.; French Conseil d' Etat Decision on Tax Treaty Overriding CFC Legislation, Tax Analysts Tax Document Service 2002, Doc. 2002 - 15798; Vogel, France's Conseil D'Etat: Tax Treaties Prevail Over CFC Rules, Bulletin for International Fiscal Documentation 2002, page 498; Conseil d'Etat Decision on Tax Treaty Overriding CFC Legislation, Tax Notes International 2002, page 265; News Analysis: France-Switzerland Treaty Overrides CFC Regime, French Tax Court Rules, Tax Notes International 2002, page 143; Bourtourault / Mbwa-Mboma, French High Tax Court Confirms that the Former France-Switzerland Tax Treaty Overrides the French CFC Legislation, Intertax 2002, page 493 et seq.; Anthony, France-Switzerland Treaty Overrides CFC Legislation, French Courts Says, International Tax Report 2002, pages 10, 11; Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq.; Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Baker, Seminar B: Jüngste Entwicklungen im Internationalen Steuerrecht, Internationales Steuerrecht 2002, page 546 et seq.; Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq.; Aigner, Die Abkommensberechtigung bei Anwendung von CFC-Gesetzgebungen, Internationale Wirtschafts-Briefe 2002, page 1637 (1638); Pouletty, Consequences Arising from the Decision on French CFC Rules, Tax Planning International European Union Focus 2002; Pouletty, French CFC Rules, Tax Planning International Focus, 2002; Olléon, Article 209 B et conventions fiscales internationales: après les ténèbres, la lumière, Revue de jurisprudence fiscale 2002, pages 755-759 and 786-789; Acard, note in Banque & Droit, no. 84, July-August 2002, page 56; Blaise, Fiscalité internationale: article 209 B et conventions fiscales', BF Francis Lefebvre, 11/02, page 763; Boutemy et al., note in Petites Affiches, 2002, no. 171, page 4; Vogel, France's Conseil D'Etat: Tax Treaties Prevail Over CFC Rules, Bulletin for International Fiscal Documentation 2002, page 498 et seq.; Portner, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International 2002, page 1679 et seq. (1688-1690); French Supreme Court holds French CFC legislation incompatible with treaties in case regarding France-Switzerland treaty, Tax News Service, July 2, 2002; European Commission issues formal notice to France on application of French CFC rules to Luxembourg captive insurance companies, Tax News Service, July 9, 2002; French Tax Review: Tax Treaties Trump French CFC Law, Court Reaffirms, Tax Notes International 2003, page 1011; Gutmann / Danon / Salome, French-Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of income Requirement in International Tax Law, Intertax 2003, page 156 et seq.; Estoile-Campi, Waterloo, morne plaine: l'article 209 B après l'arret Schneider, Revue de jurisprudence fiscale 2003, pages 113-114; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 126; Kabbaj /Raingeard de la Bletière in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, page 237 et seq.; Goulard / Jolly, French Lawmakers Revisit CFC Rules, Tax Notes International 2005, page 219 et seq; Ippolito / Pontnau-Faure, France: CFC Rules Reform, Tax Planning International Transfer Pricing 2005, page 10; Brähler, Controlled Foreign Companies-Rules, 2007, page 38; Malherbe et al., Controlled Foreign Corporations in the EU After *Cadbury Schweppes*, Tax Management International Journal 2007, page 607 et seq.; see with respect to a subsequent decision of the Lower Court of Lille: TA Lille 9 janvier 2003 no. 99-187: Société 3 Suisses International, Revue de jurisprudence fiscal 2003, pages 325-326; Prééminence des stipulations conventionnelles sur l'article 209 B du CGI, Revue de droit fiscal 2003, pages 586-587; Mbwa-Mboma, French Tax Review: Tax Treaties Trump French CFC law, Court Reaffirms, Tax Notes International 2003, pages 1011-1012; see with respect to the question of the consistency of CFC legislation and (French) tax treaties, in general, also the FEE

was a pure holding company and its sole activity consisted of the holding and management of bonds and securities. *Schneider* tax returns were audited by the French tax authorities. As a result of the inspection, *Schneider* was required by the French tax authorities to pay additional corporate income tax on the profits made by the Swiss subsidiary in 1986 under Section 209 B of the French Tax Code.[31]

After unsuccessfully opposing the reassessment, *Schneider* brought the case to trial. The Lower Tax Court of Paris confirmed the view of the tax authorities in its decision[32] and ruled – in line with a previous decision[33] – that Section 209 B did not violate the France-Switzerland tax treaty. The judges considered that Section 209 B does neither lead to a juridical nor to an economic double taxation. The argument against a juridical double taxation, i.e. a double taxation of the same taxpayer on the same income by at least two different countries, is basically that the tax is imposed on the French corporation and not on the CFC. Economic double taxation is eliminated by offsetting taxes of the same nature paid by the CFC outside France against the French corporate tax.[34] In addition, one of the purposes of the tax treaty, to combat tax avoidance, can also be achieved through the domestic CFC legislation.

Schneider appealed to the Paris Court of Appeals with two arguments: (i) the Swiss corporation should benefit from the "safe haven clause" of Section 209 B-II, and (ii) Section 209 B-I was incompatible with the France-Switzerland tax treaty. The safe haven clause of Section 209 B-II would enable the *Schneider* corporation to avoid the application of Section 209 B-I. However, *Schneider* was not able to demonstrate that the Swiss subsidiary had substantial commercial or industrial activities in the Swiss market with unrelated parties. As already mentioned above, *Paramer* was a pure holding company and its sole activity consisted of the management of portfolio securities. The Court confirmed the tax authorities' view that a pure holding company is not within the scope of Section 209 B-II.[35]

The second argument was more important: The France-Switzerland tax treaty of September 1966 stipulates in Article 7 (1) that "*the profits of (a Swiss) enterprise (...) shall be taxable only in (Switzerland) unless the enterprise carries out a business in (France) through a permanent establishment situated therein*." The Court concluded that pursuant to Article 7 (1) of the France-Switzerland tax treaty France was not in a position to tax the profits of the Swiss subsidiary, because *Paramer* did not carry out business in France through a permanent establishment. The treaty must therefore prevail over the domestic CFC legislation and even the need by one contracting state to fight international tax avoidance could not authorise a violation of the tax treaty. There is nothing included in the tax treaty that permits any derogation of the treaty's profit allocation rules. The decision of the Paris Court of Appeals[36] is consistent with previous decisions rendered by two French lower tax courts.[37]

Position Paper on Controlled Foreign Company Legislations in the EU, European Federation of Accountants, April 2002, pages 12, 13.

[31] ITLR, Volume 4, 2002, page 1077.

[32] Lower Tax Court of Paris, dated February 13, 1996.

[33] Schneider Case, dated November 21, 1995 – there was no appeal against this decision.

[34] This is in line with the regulations of the French tax authorities, Regulations 4H-9-92 of March 6, 1992.

[35] Regulations 4H-3-98 of April 17, 1998, no 203 sq.; Mbwa-Mboma, Treaty with Switzerland Overrides French CFC Legislation, French High Tax Court Confirms, Tax Analysts Tax Document Service 2002, Doc. 2002-15647.

[36] Paris Court of Appeals, dated January 30, 2001. See with respect to this decision: Chahid-Nourai / Couturier, L'article 209 B est-il soluble dans le droit fiscal international?, Revue de droit fiscal 2001, page 333 ; Amonn,

The government appealed to the French Supreme Tax Court and raised three arguments: Firstly, Schneider was not entitled to invoke the provisions of the France-Switzerland tax treaty since it is intended to eliminate "legal" (juridical) double taxation, i.e. the taxation by France and Switzerland of the same item of income in the hands of the same taxpayer for the same taxable year. The government argued that the French company which had to pay the French corporate tax under the CFC rules did not pay Swiss corporate tax on the same income. Therefore, no juridical double taxation occurred and the tax authorities did not violate the purpose of the tax treaty. Secondly, the decision of the Paris Court of Appeals relying on the profit allocation rules of Article 7 (1) of the treaty was an error in law. The attribution of income pursuant to Section 209 B is a deemed dividend rather than a business profit. What the CFC legislation seeks to attack is not profits resulting from the carrying on of business which should have been taxed in France, but the deliberate non-distribution of their profits by subsidiaries of resident shareholders. There are no provisions included in the tax treaty which prevent the application of the French CFC rules. However, the government counsel explained that the deemed distribution does not constitute a dividend in the sense of Article 11 of the France-Switzerland tax treaty. This is due to a former judgement on the application of identical provisions of the France-Netherlands tax treaty where the Court held that dividends in the sense of this provision must be defined according to the definition given in internal law of the notion of dividends as *"earnings distributed by a company to its participants by virtue of a decision taken by the general assembly of its shareholders."* [38] That is not what is understood in the case of deemed distributions taxed by virtue of Article 209 B. Therefore, the government counsel concluded that Article 23 of the France-Switzerland tax treaty[39] is applicable with the effect that, nevertheless, the taxing right is attributed to France.[40] Thus, the CFC taxation is in line with the conclusion of the OECD base companies report which states in paragraph 45 that *"if the counteracting measures have the effect of taxing a deemed dividend of a base company, this is well within the taxing rights conferred on the taxpayers country of residence under the rules of tax treaties regarding taxation of dividends."* [41] Article 7 (1) of the France-Switzerland tax treaty is therefore not applicable in the underlying case. Thirdly, the Paris Court of Appeals ignored the aim of the treaty to combat international tax avoidance.

Zweitinstanzliches Urteil zur Anwendbarkeit der französischen CFC-Regelung im Verhältnis zur Schweiz, Archiv für Schweizerisches Abgaberecht 2001, page 177 ; Coin, French CFC Rules in Conflict With French-Swiss Income Tax Treaty, Paris Court Says, Tax Notes International 2001, page 1233 et seq. ; Gorringe, OECD Member States Tighten Up Their CFC Rules, Tax News International, April 11, 2001; D'Hont / Souchal, Significant CFC Victory for Taxpayers, Tax Planning International Review 2001; Tax Treaty with Switzerland Overrides French CFC Legislation, Paris Appeals Court Rules, Tax Notes International 2001, page 1377; French CFC Legislation Incompatible with France-Switzerland Tax Treaty, Tax Notes International 2001, page 591; French Tax Code Incompatible with France-Switzerland Tax Treaty, Tax Notes International 2001, page 211; Richter, Neueste Entwicklung der französischen Rechtsprechung zum Außensteuerrecht bei DBA-Staaten, Internationales Steuerrecht 2002, page 231 et seq.; Douvier / Bouzoraa, Court of Appeals Confirms Incompatibility of CFC Rules with Tax Treaties, European Taxation 2001, page 184 et seq.

[37] Strafor-Facom Case, Lower Tax Court of Strasbourg, dated December 12, 1996 and Rémy-Cointreau Case, Lower Tax Court of Poitiers, dated February 25, 1999. See with respect to the latter decisions also Douvier in IFA, Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends, National Report France, 2001, page 495 et seq. (507, 508).

[38] *Banque francaise de l'Orient*, October 13, 1999, appeal no. 190 083, RJF 12/99, n 1587, DF 6/00, c 71, CE.

[39] Article 21 of the OECD-MTC; *SA Bank Polska*, January 31, 2001, appeal no. 199 543, RJF 4/01, n 489, DF 20/02, c 422, BDCF 4/01, n 489, CE.

[40] Article 23 of the France-Switzerland tax treaty states that "(...) *items of income of a resident of a Contracting State not dealt with in the foregoing Articles (...) shall be taxable only in that State*."

[41] International Tax Law Reports (ITLR), Volume 4, 2002, pages 1123, 1124.

The Court did not follow the deemed dividend approach of the government and stated that *"it results from the exact terms of these provisions (Section 209 B) that their purpose is to allow the taxation in France of business profits generated by a corporation carrying out its activities abroad and not, contrary to the argument of the minister, the taxation of a deemed dividend distribution by the foreign corporation to its shareholder that is a resident in France."* For this characterisation, the Court referred to Article 3 (2) of the France-Switzerland tax treaty[42] and consequently to French law. The Court followed the clear wording of the provision which refers to the taxation of "*profitable results of the foreign company*"[43] determined according to French tax rules. The Court held that nothing under Section 209 B supported the characterisation of that income as a deemed dividend.

The government counsel explained that - in case the income is characterised as business profits - Article 7 (1) is nevertheless not applicable. Article 7 (1) must be seen in conjunction with Article 5 of the France-Switzerland tax treaty regarding permanent establishments. In that context a double taxation, by France and Switzerland, of the same profits of a resident of one contracting state with no permanent establishment in the other contracting state shall be prevented. However, France does not tax a Swiss resident with no permanent establishment in France, but a French resident pursuant to Section 209 B. In addition, the profits realised by *Schneider* through its wholly owned subsidiary do not fall within the scope of Article 7 (1), which applies only to profits made directly by a resident of one contracting state. Essentially, the income attributed to the French shareholder must be distinguished from the profit of the CFC. There is no taxation of a permanent establishment and there is no taxation of a Swiss subsidiary in France. These arguments have to be seen together with the purpose of the OECD Model Tax Convention to eliminate juridical double taxation, i.e. the taxation by two contracting states of the same income in the hand of the same taxpayer for the same taxable year.[44]

The Court rejected these arguments and held that there were no legal grounds for distinguishing between the business profits of the CFC and the income attributable to the French corporate shareholder. There is an "*identity of nature*" between the profits of the Swiss subsidiary and the income under Section 209 B.[45] The Court stated that *"(t)he objective of eliminating double taxation which is attributed to this (France-Switzerland) tax treaty does not justify a misapplication of the provisions quoted above on the sole ground that the taxation in France of the profits of the (Swiss) Paramer company is not carried out in the name of the Swiss company but in that of its parent company which is a separate legal entity and to whom these profits have*

[42] Article 3 (2) of the France-Switzerland tax treaty is similar to Article 3 (2) of the OECD-MTC.

[43] Section 209 B (1) in the version applicable to the taxation under dispute (see International Tax Law Reports (ITLR), Volume 4, 2002, page 1107): When an enterprise subject to corporation tax holds directly or indirectly at least 25 percent of the shares or rights in a company established in a foreign state or a territory situated outside of France whose fiscal regime is privileged in the sense explained in Article 238 A, that enterprise is subject to corporation tax on the profitable results (résultats bénéficiaires) of the foreign company in proportion to the interest it holds in it. These profits (bénéfices) are subject to separate taxation. They are regarded as having been received on the first day of the month following the accounting date of the foreign company and are to be determined in accordance with the rules established by this Code. Any tax paid locally by the foreign company is creditable in the proportion mentioned in the first paragraph against the tax imposed in France provided it is comparable to the corporation tax.

[44] ITLR, Volume 4, 2002, pages 1125, 1126.

[45] ITLR, Volume 4, 2002, page 1108; see also Vogel, France's Conseil D'Etat: Tax Treaties Prevail Over CFC Rules, Tax Treaty News, Bulletin for International Fiscal Documentation 2002, page 498.

not in fact been distributed. It follows that the court below did not commit an error in law in deciding that the provisions of art 7 of the Franco-Swiss tax treaty prevent the application of the provisions of art 209 B of the CGI."[46] Pursuant to the Court, the scope of the tax treaty is broader than just preventing the taxation by two countries of the same taxpayer for the same item of income and the same taxable period. With that view, the Court found the distinction between "juridical" and "economic" double taxation to be artificial.[47] Due to the fact that the Swiss subsidiary had its effective place of management in Switzerland and did not carry out business activities in France through a permanent establishment, Article 7 (1) of the France-Switzerland tax treaty attributes the taxing rights to Switzerland and prevents the tax authorities in France from taxing that income under their CFC legislation.

With regard to the argument of tax avoidance, the Court held that France cannot apply its domestic anti-avoidance legislation *"(…) in the absence of express provisions*" in the tax treaty.[48] The aim of fighting tax avoidance cannot override the allocation rules unless it is clearly stipulated in the tax treaty. According to Aigner, the reference to the aim of fighting tax avoidance in the preamble of the tax treaty is not sufficient to deny tax treaty protection. In this respect, Aigner agrees with the position of the Court that express provisions in the tax treaty are required.[49] A similar comment was made by Richter who stated that the preamble of a tax treaty is not a legal norm and therefore cannot transfer rights and obligations similar to the express provisions stipulated in the tax treaty.[50] I fully agree with the latter positions. It would not be acceptable to deny tax treaty protection only on the basis of a general reference in the preamble. However, whether this conclusion will finally be of importance for the application of CFC rules is a different question which will be answered in this chapter.

In any event, the decision of the French Supreme Tax Court in the *Schneider* Case is an important decision with significant consequences for the French CFC legislation. Commentators even considered the decision to be one of the "great sentences" of the French jurisprudence in the field of international taxation.[51] However, in my opinion, the decision can also be regarded as an exceptional decision. The main reason for considering the decision as an exceptional one is the fact that the Court, in essence, rejected the differentiation between "juridical" and "economic" double taxation. Consistently, the "identity of nature" between the profits of the subsidiary in Switzerland and the income pursuant to the CFC regime prevents France from taxing

[46] ITLR, Volume 4, 2002, page 1108.
[47] Mbwa-Mboma, Treaty with Switzerland Overrides French CFC Legislation, French High Tax Court Confirms, Tax Analysts Tax Document Service 2002, Doc. 2002-15647; with regard to legal and economic double taxation see also Lessambo, French CFC Legislation: The End of a Legislatively Controversial Rule, Tax Planning International Financing 2002.
[48] International Tax Law Reports (ITLR), Volume 4, 2002, page 1108.
[49] Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq. (410); see also Aigner, Die Abkommensberechtigung bei Anwendung einer CFC-Gesetzgebung, Internationale Wirtschafts-Briefe 2002, page 1637 et seq.
[50] Richter, Conseil d'Etat bestätigt Vorrang des DBA-Rechts von nationaler Hinzurechnungsbesteuerung, Internationales Steuerrecht 2002, page 653 et seq. (653).
[51] Gutmann / Danon / Salome, French-Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law, Intertax 2003, page 156 et seq. (156). Pursuant to Bérengier, the fact that the French Supreme Tax Court did not follow the opinion of the Government Counsel (*Commissaire du Gouvernement*), contrary to usual practice, makes this decision even more significant (Bérengier, French Administrative Supreme Court Holds that Tax Treaties Override French CFC Rules, Tax Planning International Review 2002, page 3 et seq. (4)).

the income (because the Swiss subsidiary company did not have a permanent establishment in France which would otherwise have allowed the latter state to tax such profits). I cannot follow the approach of the French Supreme Tax Court with respect to the non-acceptance of the separation between juridical and economic double taxation. International juridical double taxation is defined as "*the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods*."[52] However, it is apparent, in my opinion, that the French parent company and the Swiss subsidiary company have to be seen, in the context of the respective double tax convention, as two different persons (and taxpayers). Thus, the requirement of "*the same taxpayer*" is not fulfilled. What remains is an economic double taxation, i.e. "*the imposition of taxes in two (or more) States on the same economic transaction, item of income or capital during the same period, but in the hands of different taxpayers*."[53] The fact that one state (France) establishes a link within its domestic legislation to income derived through a foreign entity is not sufficient, in my opinion, to consider the differentiation to be "artificial." Pursuant to Lang, it makes no difference from a tax treaty perspective whether the legislator stipulates a connection to the attributable income with an explicit reference to the income of the foreign entity or in an abstract way without such an explicit reference. This is not more than a "legislative technique" which is irrelevant for the qualification under the tax treaty. Moreover, there is no rule on the attribution of income in tax treaties which makes the decision of one of the two contracting states binding for the other contracting state. Both states are free to describe the circumstances which result in taxable income in their national legislation.[54] Thus, it is in the discretion of each state to establish such a link as long as it does not lead to a circumvention of the allocation of taxing rights stipulated in the respective double tax convention - which, in my opinion, is not true in case of CFC taxation. There might be an "identity of nature" - in the sense that the profit of the foreign company and the income of the shareholder (based on the CFC rules) are related to one and the same income-producing process - but the income is nonetheless allocated to *two different taxpayers* by two different states. Overall, from my perspective, the application of the French CFC regime neither leads to a juridical double taxation nor does the concept of CFC taxation (and the link to the income derived through the foreign company) allow the conclusion that the differentiation between the two types of international double taxation is to be considered an artificial differentiation. Hence, what remains is the question whether international economic double taxation is within the scope of the respective double tax convention. If the tax treaty follows the lines of the OECD-MTC, it is necessary to take into account, in this regard, the Commentary to the OECD-MTC. The Commentary on Article 1 of the OECD-MTC clearly refers to "*(...) problems that arise in the field of international juridical double taxation*"[55] and the Commentary on Articles 23 A and 23 B of the

---

[52] Commentary to the OECD-MTC, Introduction, paragraph 1.

[53] See Kemmeren, Principle of Origin in Tax Conventions, A Rethinking of Models, page 14 and the references in footnote 11; Commentary on Articles 23 A and 23 B, paragraph 2.

[54] Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (720); Lang, CFC-Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; see also Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, General Report, 2004, page 33. See with regard to German CFC rules and the "representation theory" / "distribution theory" Debatin, Treaty Override, Der Betrieb 1992, page 2159; Menck, Rechtsmechanismus und Rechtscharakter der Zugriffsbesteuerung, Deutsche Steuer-Zeitung 1978, page 106 et seq.; Wassermeyer, Festschrift für Werner Flume, 1978, page 323 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, page 156 et seq.

[55] Commentary, Introduction, paragraph 3.

OECD-MTC stipulates that "*these Articles deal with the so-called juridical double taxation (...). This case has to be distinguished especially from the so-called economic double taxation (...). If two States wish to solve the problems of economic double taxation, they must do so in bilateral negotiations*."[56] Therefore, a double tax convention which is based on the OECD-MTC does not, in general, encompass the avoidance of international economic double taxation. Hence, I cannot agree with the outcome of the *Schneider* Case since the France-Switzerland double tax convention neither explicitly referred to a non-application of the French CFC regime in the relationship of the two states nor to an extension of the tax treaty to the avoidance of international economic double taxation.[57]

In tax literature, there are a great number of articles which focus on the description of the decision in the *Schneider* Case and the possible consequences, especially with respect to the (specific) French tax treaty situation.[58] Here, I will not go into further detail of these articles and the tax treaty situation of France. Instead, I will refer to some commentators which made more general comments and remarks which might be of relevance in the context of this chapter as well. For example, according to Mbwa-Mboma, the decision of the Conseil d'Etat is welcome because it confirms the precedence of tax treaties over domestic rules and protects the useful effect of the profit allocation rules under the tax treaties. Mbwa-Mboma further concluded that in order to overcome the strict business profits characterisation of CFC income the government might change the tax law and treat the income as a deemed dividend.[59] Donsimoni made the same proposal by suggesting that the definition of foreign source income should refer to deemed distributed income.[60] Pouletty confirmed that the decision is of importance as it clearly defines the relationship between domestic laws and tax treaties.[61] The article of Lessambo refers to the question of juridical vs. economic double taxation.[62] Lessambo concluded that there is an issue of juridical double taxation (or legal double taxation) by "grasping" the same benefits from the taxpayer twice. First, from the French corporation and, second, from the foreign corporation via the French corporation, according to the proportion held in the foreign company. Lessambo did not go into more detail of his conclusion to the juridical double taxation. Instead, he proceeded to criticise, in my opinion correctly, the biased nature of the CFC regime, e.g. by not reflecting appropriately the losses of the foreign entity under the French CFC regime. In his opinion, the biased nature of CFC legislation was not considered appropriately in the decision. In fact, the statement of Lessambo was a direct response to the comments of Gutmann - made in the context of the decision of the Paris Court of Appeals.[63] Gutmann concluded that "in strict law"

[56] Commentary on Articles 23 A and 23 B, paragraphs 1 and 2.
[57] The article of Not presents a table with French tax treaties which contain a clause (in the treaty or protocol) where France reserves its right to apply Article 209 B of the French Tax Code (Not, French CFC Rules Held Incompatible with OECD Model Tax Convention, Tax Planning International Review 2002, page 3 et seq.).
[58] For an overview, see the references made earlier in this section.
[59] Mbwa-Mboma, Treaty with Switzerland Overrides French CFC Legislation, French High Tax Court Confirms, Tax Analysts Tax Document Service 2002, Doc. 2002-15647.
[60] Donsimoni, Schneider Case Clarifies Application of Tax Treaties to French Companies, Tax Analysts Tax Document Service 2002, Doc. 2002-18637.
[61] Pouletty, French CFC Rules, Tax Planning International Focus, 2002; see in this respect also Richter, Conseil d'Etat bestätigt Vorrang des DBA-Rechts von nationaler Hinzurechnungsbesteuerung, Internationales Steuerrecht 2002, page 653 et seq. (654).
[62] Lessambo, French CFC Legislation: The End of a Legislatively Controversial Rule, Tax Planning International Financing 2002.
[63] Gutmann, L'article 209B du CGI-le Debut de la Fin?, Dr. 21, 2001, ER 018 ; see also Lessambo, French CFC Legislation: The End of a Legislatively Controversial Rule, Tax Planning International Financing 2002.

the French CFC regime does not create a double taxation. The latter regime authorises the French corporation to deduct the equivalent taxes imposed abroad from its benefits. Looking at the position of Lessambo and Gutmann, it seems to me that "a balance" can be found between the two positions. Juridical double taxation was defined as "the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods."[64] I have already made it clear that, in my opinion, a juridical double taxation does not exist in this case and, for this reason, I cannot follow the position of Lessambo in this respect. However, CFC taxation results in an economic double taxation and it is not unlikely, as I have outlined in chapter 6, that complete relief from double taxation cannot be achieved. For this reason, the criticism which is directed towards an unsymmetrical CFC regime is clearly to be supported.

However, it was Vogel who congratulated the Supreme Tax Court on its decision. In his view, the decision calls in mind that it is indeed the income of the foreign entity which is taxed in France and that such taxation is contrary to the basic principles of tax treaty law.[65] This, of course, can be seen as a more general criticism of the concept of CFC taxation. According to the analysis of Gutmann, Danon and Salome, the French CFC regime refers, at the point in time relevant for the decision, to the profits of the foreign entity.[66] For this reason they concluded that it is consistent, in the absence of a permanent establishment, that France does not have the right to tax the income of the foreign entity.[67] However, the French CFC legislation was subsequently amended and based on the revised wording of article 209B the attributed income is deemed to constitute a profit of the parent company in France (in contrast to the wording which was relevant for the decision in the *Schneider* Case and which, in essence, qualified the attributed income to be the beneficiary result of the foreign entity). Here, Gutmann, Danon and Salome raised the question whether the revised wording has any consequence or whether the difference is only formal - as it was basically suggested by Dibout who considered the difference in the wording to be of no significance at all. Finally, Gutmann, Danon and Salome concluded that it is possible to be seen as just a formal difference, but "it is not obvious."[68] Here, I will not go into further detail of the domestic qualification of CFC income under French law and the question whether the domestic qualification should have any influence on the income allocation rules under the tax treaties. This question will be verified in more detail later on.

[64] Commentary to the OECD-MTC, Introduction, paragraph 1; see chapter 3 for further details to international juridical double taxation.
[65] Vogel, France's Conseil D'Etat: Tax Treaties Prevail Over CFC Rules, Bulletin for International Fiscal Documentation 2002, page 498 et seq.
[66] Gutmann / Danon / Salome, French-Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law, Intertax 2003, page 156 et seq.
[67] Gutmann / Danon / Salome, French-Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law, Intertax 2003, page 156 et seq. (162).
[68] Gutmann / Danon / Salome, French-Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law, Intertax 2003, page 160, footnote 25; Dibout, L'inapplicabilité de l'article 209 B du CGI face à la Convention fiscale franco-suisse du 9 septembre 1977, Revue de droit fiscal 2002, no. 36, page 1133 et seq. (1136).

7.2.3. The *Bricom Holdings* Case (The United Kingdom)

The *Bricom Holdings* Case[69] is dated before the French *Schneider* Case and the Finnish *A Oyj Abp* Case. *Bricom Holdings Ltd. (Bricom)* was the 100 percent shareholder of a company incorporated and resident in the Netherlands, called *Spinneys International BV (Spinneys). Spinneys* was an investment holding company. *Bricom* was part of a United Kingdom based group of companies which were, directly or indirectly, 100 percent shareholders of *Spinneys.* The companies in the United Kingdom borrowed substantial sums of money from *Spinneys* and paid interest thereon which represented a substantial portion of *Spinneys* profits. *Bricom* – as the direct 100 percent shareholder of the subsidiary in the Netherlands – was assessed under the United Kingdom CFC regime.[70]

Bricom filed an appeal against the assessment on the grounds that the assessment included amounts that were excluded from tax in the United Kingdom under the 1980 United Kingdom-Netherlands tax treaty. Article 11 (1) of the tax treaty provides that *"interest arising in one of the States which is derived and beneficially owned by a resident of the other State shall be taxable only in that other State."* According to *Bricom*, the effect of the assessment under the CFC regime was to tax interest arising in the United Kingdom that was beneficially owned by a resident of the Netherlands and that this amount was exempt from tax in the United Kingdom under Article 11 of the United Kingdom-Netherlands tax treaty.[71] The assessment was defended by arguing that the tax according to the CFC regime was based on a "wholly notional amount" and not on the interest income of the subsidiary in the Netherlands. Therefore, Article 11 of the tax treaty was not applicable. In addition, the CFC regime was not a corporation tax or a substantially similar tax which would be necessary to qualify for relief under the treaty. These arguments were based on the technical language of the CFC provisions which mentioned "chargeable profits" of the

[69] Bricom Holdings Ltd. v. IRC, (1996) STC (SCD) 228, appeal dismissed (1997) STC 1179 (CA).

[70] Sandler, British Tax Review (BTR) 1998, page 52 et seq. (52). See with respect to the Bricom Holdings Case also Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 202 et seq.; Clayson, The Impact of European Law and Treaty Relief on the UK Controlled Foreign Companies Rules, Intertax 1998, page 326 et seq. ; Cristie / Sheiham, Bricom, The Tax Journal 1997, pages 13-14 ; Schwarz, Controlled Foreign Companies and Tax Treaties, Bulletin for International Fiscal Documentation 1997, page 553 et seq. ; Simpson / Venables, Bricom Again ; The Bricom Decision, The Offshore Tax Planning Review 1997, page 97 et seq.; Malherbe et al., Controlled Foreign Corporations in the EU After *Cadbury Schweppes*, Tax Management International Journal 2007, page 607 et seq.; Ullah, National Report UK, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, page 626 et seq.; Venables, Double Taxation Treaties: The Antidote to Anti-Avoidance Provisions?, The Offshore Tax Planning Review 1996, page 151; Venables, Treaty Override: *Bricom Holdings Ltd v IRC* in the Court of Appeal, The Offshore Tax Planning Review 1997, page 151; Hinds, Upstream Attribution of Income and Gains and Double Tax Treaty Relief: Some Implications of the Bricom Decision, EC Tax Journal 1997, page 162; Friel, National Report UK, in IFA, Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends, 2001, page 893 et seq.; Portner, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International 2002, page 1679 et seq. (1688); see with respect to the question of the consistency of CFC legislation and (the UK) tax treaties, in general, also the FEE Position Paper on Controlled Foreign Company Legislations in the EU, European Federation of Accountants, April 2002, pages 12, 13.

[71] Sandler, British Tax Review 1998, page 52 et seq. (53). In the *Bricom* case, Lord Justice Millet expressed surprise that the issues had not previously come before the courts, given their fundamental nature and the fact that CFC legislation had been in force for more than 12 years. The Inland Revenue claimed that this was because its understanding of the effect of the provisions is so obviously correct that no one had considered it worthwhile to challenge it before (see Schwarz, Controlled Foreign Companies and Tax Treaties, Bulletin for International Fiscal Documentation 1997, page 553 et seq. (558)).

CFC and its "creditable tax."[72] Pursuant to the CFC regime, *"a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits, less the portion of the (CFC's) creditable tax for that period (if any) which is apportioned to the resident company, shall be assessed on and recovered from the resident company as if it were an amount of corporation tax chargeable on that company."* [73] The "appropriate rate" is defined as the rate of corporation tax applicable to the resident company for its accounting period in which the accounting period of the CFC ends.[74] The "chargeable profits" are defined as the "total profits" of the CFC, excluding capital gains, calculated in accordance with the assumptions in Schedule 24.[75] The Special Commissioners considered the CFC regime a three-stage process: First, chargeable profits are computed in accordance with the various assumptions in Schedule 24; secondly, the profits are apportioned to the persons having an interest in the CFC; and thirdly, certain United Kingdom corporations are assessed based on the chargeable profits less the creditable tax apportioned to them. Pursuant to the Special Commissioner, the interest lost its original character at the first stage of the process and became one ingredient in the determination of the chargeable profits of the CFC.[76]

The main argument of the taxpayer before the Court of Appeal was that the amount apportioned in stage two of the process was the chargeable profits of *Spinneys* and that these chargeable profits included exempt United Kingdom-source income. However, the Court of Appeal compared the CFC provisions with a deeming provision in two earlier cases[77] and came to the conclusion that *"the interest received by Spinneys is not included in the sum apportioned to the taxpayer on which tax is chargeable. It merely provides a measure by which an element in a conventional or notional sum is calculated, and it is that conventional or notional sum which is apportioned to the taxpayer and on which tax is charged."* [78]

Sandler raised the question whether it would have been better to base the arguments on Article 7 (1) or Article 10 (7) of the United Kingdom-Netherlands tax treaty instead of Article 11.[79] The same question was raised by Clayson with regard to Article 7 (1) of the United Kingdom-Netherlands tax treaty.[80] Article 7 (1) of the tax treaty states that *"the profits of an enterprise of one of the States shall be taxable only in that State unless the enterprise carries on business in the other State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment."* Since *Spinneys* did not have a permanent establishment in the United Kingdom, the profits should be excluded from United Kingdom taxation. Article 10 (7) states in part *"where a company which is a resident in one of the States derives profits or income from the other State, that other State may not (...) subject the company's undistributed profits*

[72] Section 747 (3) CITA.
[73] Section 747 (4) (a) CITA.
[74] Section 747 (4) CITA.
[75] Section 747 (6) CTA.
[76] Sandler, BTR 1998, page 52 et seq. (53).
[77] IRC v. Australian Mutual Provident Society (1947) AC 605 (HL), Ostime v. Australian Mutual Provident Society (1960) AC 459 (HL).
[78] (1997) STC 1179, on page 1195.
[79] Sandler, BTR 1998, page 52 et seq. (56).
[80] Clayson, The Impact of European Law and Treaty Relief on the UK Controlled Foreign Companies Rules, Intertax 1998, page 326 et seq. (328).

to a tax on the company's undistributed profits, even if (...) the undistributed profits consist wholly or partly of profits or income arising in such other State." Also in this case it could be argued that the United Kingdom cannot charge a tax on the undistributed profits of the subsidiary in the Netherlands.

However, it seems that the Court of Appeal would also have rejected arguments based on Article 7 (1) and Article 10 (7) of the United Kingdom-Netherlands tax treaty. The Court held that *"chargeable profits as defined by s. 747 (6) (a) are a purely notional sum. They do not represent any profits of Spinneys on which United Kingdom corporation tax is chargeable, for there are no such profits. Nor do they represent any actual payments or receipts of Spinneys, whether of interest or anything else. They are merely a product of a mathematical calculation made on a hypothetical basis and making counterfactual assumptions. The "chargeable profits" which are defined by s. 747 (6) (a) exist only as a measure of imputation. What is apportioned to the taxpayer company and subjected to tax is not Spinney's actual profits but a notional sum which is the product of an artificial calculation."* [81] Clayson identified a "clear correlation" between the profits of the CFC and the attributed income under the CFC regime, but finally also concluded that it is probable that the Court of Appeal would have followed a similar reasoning, i.e. that the tax treaty would not restrict the taxation of the purely notional sum computed with reference to the profits of the CFC.[82] Cristie and Sheiham highlighted in their conclusion the comments made by the Court of Appeal in relation to the statutory interpretation in this case. The Court must attempt to ascertain the intention of the Parliament from the words used in the light of the legislative purpose. The Court found that the assumptions which the CFC rules require are not additional assumptions to be made in combination with the actual facts, but rather the CFC rules require a substitution for the actual facts. In this respect, *Spinneys* should be assumed not to be resident in the Netherlands for the purposes of assessing its chargeable profits, so that relief under the tax treaty was not available.[83] Venables concluded that if the CFC is deemed to be resident in the United Kingdom (just) by virtue of control, the chargeable profits should be nil. This is because even if the CFC were deemed to be resident in the United Kingdom, the CFC would still have its effective place of management abroad so that the dual residence article and other provisions of the tax treaty should exclude the profits from the hypothetical calculation.[84] In response, Avery Jones, one of the two Special Commissioners in the *Bricom Holdings* Case, stated that the CFC is assumed to be resident by virtue of control by United Kingdom residents and not by reason of domicile, residence, place of management or any other criteria of a similar nature. Accordingly, there will be no dual residence in the context of CFC taxation.[85]

Further criticism of the *Bricom Holdings* Case came from Schwarz. In his opinion, the terms of Article 11 (1) of the United Kingdom-Netherlands tax treaty are plain and

[81] (1997) STC 1179, on page 1194.
[82] Clayson, The Impact of European Law and Treaty Relief on the UK Controlled Foreign Companies Rules, Intertax 1998, page 326 et seq. (328).
[83] Cristie / Sheiham, Bricom, The Tax Journal, 1997, page 13 et seq.
[84] Simpson / Venables, Bricom Again; The Bricom Decision, The Offshore Tax Planning Review 1997, page 97 et seq.; see in this respect also Venables, Double Taxation Treaties: The Antidote to Anti-Avoidance Provisions?, The Offshore Tax Planning Review 1996, page 151; Venables, Treaty Override: *Bricom Holdings Ltd v IRC* in the Court of Appeal, The Offshore Tax Planning Review 1997, page 151.
[85] Simpson / Venables, Bricom Again; The Bricom Decision, The Offshore Tax Planning Review 1997, page 97 et seq.

should result in the obligation of the United Kingdom to exempt income arising in the United Kingdom which is beneficially owned by a resident of the Netherlands. If such income is not exempt from United Kingdom income tax and corporation tax, this will lead, according to Schwarz, to a breach of the tax treaty obligations.[86]

In my opinion, what makes the *Bricom Holdings* Case to a certain extent different from the cases described above is the fact that the Court had to deal with the question whether certain types of income which are originally derived by the CFC itself might also be included in the attributable CFC income, i.e. whether, in this particular case, the interest income derived by the CFC can also be identified in the attributable income and whether this might have the consequence that the article in the double tax convention dealing with interest income may restrict the right to tax the attributed income.[87] In my opinion, however, it is obvious that the income derived by the CFC itself - no matter what type of income it is - is different from the income which is attributable to the shareholder (parent company).[88] This, again, is first of all due to the fact that two different taxpayers are involved and that these two taxpayers do not derive *identical* income. The attributable income may be linked to the activity and / or the income of the subsidiary company, but it remains income of a different person. In this respect, I agree with the conclusion of the Court that the attributable profit does not represent interest income or any other income derived by the subsidiary company. However, this does not answer the question whether the *type of income* is the same. Thus, even though the attributable income of the parent company is not identical to the income of the subsidiary company, it might still be the same type of income, e.g. business profits or interest income. The Court in the *Bricom Holdings* Case apparently neither considered the income (or part of the income) to be interest income nor dividend income, but concluded that the “chargeable profits” under national legislation are “a purely notional sum.” It is not, in my opinion, sufficiently clear what this classification means in the context of the respective tax treaty. It might be the case that the Court did not see the necessity to deal with this question in detail because of the fact that the “chargeable profits” are, pursuant to the Court, part of the business profits of the parent company - and therefore there might be no restriction on taxing the respective income. However, from my perspective, the necessity for a classification of the attributable income in the context of the respective tax treaty remains in order to determine whether the right to tax the latter income might be restricted or not. I will go into more detail of this aspect later on.

7.2.4. The *Captive Insurance* Cases (Sweden)

In Sweden, a number of cases are pending which deal with foreign captive insurance companies. On April 4, 2005 the Swedish Council for Advance Tax Rulings[89] had to decide on two cases dealing with a Swedish parent company holding shares in a captive insurance company in Luxembourg and in Switzerland.[90] The interesting

[86] Schwarz, Controlled Foreign Companies and Tax Treaties, Bulletin for International Fiscal Documentation 1997, page 553 et seq. (556, 557).
[87] According to Cristie / Sheiham the relationship between double tax conventions and CFC rules “*is very limited in scope*” (see Cristie / Sheiham, Bricom, The Tax Journal 1997, page 13 et seq. (14).
[88] However, see the criticism of Schwarz in Schwarz, Controlled Foreign Companies and Tax Treaties, Bulletin for International Fiscal Documentation 1997, page 553 et seq. (556, 557).
[89] *Skatterättsnämnden*.
[90] The following description of the two cases is based on the articles of Mutén, Council for Advance Tax Rulings Upholds CFC Legislation, Tax Notes International 2005, page 209 et seq. and Brokelind, Group Taxation and

question in this context, of course, is the question whether the application of the Swedish CFC regime (which follows a "look-through" approach) is in line with the Sweden-Luxembourg tax treaty and the Sweden-Switzerland tax treaty, respectively. Similar to the cases outlined above, the respective tax treaties do not deal with the question of applicability of CFC rules in the relationship between the respective states. In both cases, the Swedish Council for Advance Tax Rulings came to the conclusion that the application of the CFC regime is not in conflict with the respective tax treaties. The reason is that the profit derived by the captive insurance companies in Luxembourg and Switzerland is not the same as the income which is attributable to the Swedish parent company pursuant to the CFC regime.[91] The Swedish Council for Advance Tax Rulings referred in its decision to a previous case dealing with foreign tax credits for partners in transparent entities.[92]

Moreover, the Council found that the articles dealing with dividend income are of no relevance for the income attributable under the Swedish CFC regime. If the latter income is to be qualified as business profit, it is the business profit of the Swedish parent company and not the business profit of the captive insurance companies in Luxembourg and Switzerland.[93] For this reason, there is no restriction - based on the respective tax treaties - of taxing the business profit (of the Swedish parent company) in Sweden. Alternatively, if the income is to be qualified, under the respective tax treaties, as other income, this would lead to the same outcome, namely to the taxation of the income in the residence state of the Swedish parent company.[94] Essentially, the decision of the Swedish Council for Advance Tax Rulings comes close to the outcome of the Finnish *A Oyj Abp* Case and is, once more, a deviation from the French *Schneider* Case. It is a clear statement in favour of a position which separates the income of the CFC from the income which is attributed to the shareholder (based on the applicable CFC regime) and is, therefore, a confirmation of the view that the attribution of income to the shareholder does not result in a juridical double taxation. It is also remarkable that the Council explicitly rejected the classification as dividend income in favour of business profits or, alternatively, other income. It seems that, based on the limited information available to the respective case, the Council did not see the necessity to ultimately determine the relevant article, i.e. the article related to business profits or the article related to other income, since neither of the latter two articles prevents the residence state of the shareholder from taxing the attributed income.

CFC Rules in Swedish Tax Cases, Tax Notes International 2005, page 237 et seq.; see with respect to the Swedish cases also Schönfeld / Lieber, Nun auch schwedische Hinzurechnungsbesteuerung auf dem Prüfstand des EG-Rechts, Finanz-Rundschau 2005, page 927 et seq.; Schönfeld / Lieber, Swedish CFC-Rules under Scrutiny of EC Law: Harmful Tax Competition and the Free Movement of Capital in Relation to Third Countries, Intertax 2006, page 96 et seq.; information can also be found under www.skatteverket.se.

[91] See Mutén, Council for Advance Tax Rulings Upholds CFC Legislation, Tax Notes International 2005, page 209.

[92] See Mutén, Council for Advance Tax Rulings Upholds CFC Legislation, Tax Notes International 2005, page 209; see with respect to the decision which deals with the Swedish tax credit system in relation to an investment of a Swedish corporation in US limited partnerships and single-member limited liability companies: Mutén, Finance Minister Proposes Revision Of Foreign Tax Credit Rules, Tax Notes International 2005, page 888.

[93] See Mutén, Council for Advance Tax Rulings Upholds CFC Legislation, Tax Notes International 2005, page 209.

[94] See Mutén, Council for Advance Tax Rulings Upholds CFC Legislation, Tax Notes International 2005, page 209.

7.2.5. Excursion: Non-European Case Law

The case law dealing with the compatibility of CFC legislation and tax treaties is, of course, not limited to European Member States. For this reason, I will also make a brief excursion to two decisions which dealt with the application of the Brazilian CFC legislation and the Japanese CFC legislation, respectively.

The Brazilian decision was delivered on March 23, 2005 by the Eighth Chamber of the First Taxpayers' Council.[95] In the case at hand, *Refratec Produtos Eletrofundidos* (*Refratec*), a Brazilian company, held shares in two subsidiary holding companies established in Portugal and in Spain.[96] Instead of distributing the profits to *Refratec*, the two subsidiary holding companies retained their profits. Based on the original Brazilian legislation dealing with controlled foreign companies, the profits made by the foreign subsidiary companies would only have to be included in the Brazilian tax base if they were *actually* distributed to the parent company. However, there were also cases of *deemed distributions* which had to be included in the tax base of the Brazilian company (since, in this case, foreign profits are deemed to be "made available" to the parent company). In the underlying case, the Portuguese subsidiary was involved in a transaction which gave rise to such a deemed distribution of profits pursuant to the Brazilian legislation. In this respect, the Council found that Article 7 of the tax treaty concluded between Brazil and Portugal does not prevent Brazil from taxing the deemed distribution of profits.[97]

What makes the case interesting, however, is the fact that the Brazilian legislation was subsequently amended. The amended provision establishes an absolute presumption that foreign profits are distributed to the Brazilian company: *"(...) profits generated by foreign controlled or affiliate companies will be considered available to the Brazilian controlling company on the date of the balance sheet in which such profits have been accrued in the form (to be) established in the regulations."*[98] In effect, the profits accrued until December 31, 2001 are considered to be distributed on December 31, 2002, and the profits derived in subsequent years are deemed to be made available (fictitiously) at the end of the respective fiscal year.[99] Such an absolute presumption, of course, is a typical element of CFC regimes. In the *Refratec* decision, the undistributed profits of the Spanish subsidiary were attributed, based on the amended legislation, to the Brazilian parent company. The taxpayer argued that the CFC rules cannot be applied since Article 7 of the tax treaty concluded between Brazil and Spain stipulates that "*the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein*" and the Brazilian Federal Constitution provides that international treaties prevail over

[95] The Taxpayers' Council is the administrative court of first instance (see Branco / Berry / Lugthart / Veloci, CFC Rules Prevail over Treaty Application, Transfer Pricing International (August) 2006).
[96] Appeal No. 140,320.
[97] See Soares da Silva, Court Ruling Threatens Application of Two Tax Treaties, Tax Notes International 2006, page 205; Branco / Berry / Lugthart / Veloci, CFC Rules Prevail over Treaty Application, Transfer Pricing International (August) 2006. See in this respect also Galhardo / Lopes, Brazilian CFC Rules: Current Trends, Government Overreaching, Journal of International Taxation 2007, page 38 et seq.; Malherbe et al., Controlled Foreign Corporations in the EU After *Cadbury Schweppes*, Tax Management International Journal 2007, page 607 et seq. (see especially the references to Brazilian tax literature in Portuguese language).
[98] Article 74 of Provisional Measure 2,158; see Soares da Silva, Court Ruling Threatens Application of Two Tax Treaties, Tax Notes International 2006, page 205.
[99] For the first year, the fictitious attribution was considered to take place with one year of postponement.

domestic legislation. This argumentation was not accepted by the Council which determined that the tax treaty does not prevent Brazil from applying the Brazilian CFC legislation. It is important to note, in this respect, that the regular profit distribution of the Spanish company, in contrast to the CFC income attribution, would have been exempt from taxation based on Article 23 (4) of the tax treaty concluded between Brazil and Spain.[100] In principle, the final outcome of the decision is in line with the outcome of the case law outlined above - with the exception of the *Schneider* Case - and confirms, once more, the position that a double tax convention does not prevent the application of domestic CFC rules. However, in contrast to the *A Oyj Abp* Case, for example, the line of reasoning which was the basis for the decision remains to a large extent unclear.

The Japanese case was decided on November 1, 2007, by the Tokyo High Court and dealt with the question whether the application of the Japanese CFC legislation violates Article 7 (1) of the Japanese-Singaporean tax treaty.[101] Pursuant to the Tokyo High Court, it is obvious from the provisions of the Japanese CFC legislation that it does not directly impose Japanese taxes on the profits of the subsidiary company in Singapore, but adopts a form of “deeming taxation” in which the undistributed income of certain foreign subsidiaries meeting detailed criteria is attributed to the parent company in Japan. However, the conclusion might be different, from the perspective of the High Court, if the taxation were allowed without any limitation. In the latter case, the taxation would, in substance, result in an imposition of Japanese tax on the profits of the subsidiary company and thus undermine the purpose of Article 7 (1) of the Japanese-Singaporean tax treaty. But in the High Court’s view, that is clearly not the case with respect to the Japanese CFC legislation. As the High Court pointed out, the CFC rules define (i) the scope of the foreign subsidiary subject to the CFC rules as a foreign subsidiary which is wholly or partially owned by Japanese residents, (ii) the scope of the undistributed income of the subsidiary subject to attribution as the undistributed income in proportion to the stock ownership, and (iii) the scope of the exception to the rules as a foreign subsidiary with an economic substance as an independent entity and a business reason to operate such business in that jurisdiction. The High Court concluded that the Japanese CFC rules seek to tax, in substance, the amount that would have been repatriated to the parent company by dividends.

As to the taxpayer’s reliance on the French *Schneider* Case, the High Court found that the decision was not relevant. Pursuant to the High Court, this is due to the specific scheme under which France directly imposed the separate taxation on the undistributed profits of the subsidiary. This approach was necessary because of the French system of territorial taxation which excludes most of the foreign dividends received. Thus, according to the High Court, the French system is different from the Japanese system in a fundamental way. Moreover, the High Court took into account the conclusion of the Finnish Supreme Administrative Court in the *A Oyj Abp* Case which indicated that *Schneider* might not be a well-established international view on this issue.

[100] Soares da Silva, Court Ruling Threatens Application of Two Tax Treaties, Tax Notes International 2006, page 206; Branco / Berry / Lugthart / Veloci, CFC Rules Prevail over Treaty Application, Transfer Pricing International (August) 2006.
[101] Tokyo High Court, 2007 (Gyo-Ko), No. 148; The description of the case is based on the article of Honda / Ault, Japanese CFC Rules Consistent With Treaty, Court Holds, Tax Notes International 2008, page 875 et seq.

The High Court also rejected the position that the CFC rules cannot be applied if the tax treaty does not explicitly allow the application of such rules. In this respect, the High Court referred to the OECD-Commentary[102] and concluded that the Commentary has been widely recognised as being of great assistance in the application and interpretation of the articles of the OECD-MTC. Although not legally binding - according to the High Court - it is persuasive as to the conclusion that tax treaties could generally be considered not to preclude CFC-type rules in domestic legislation, including the Japanese rules. The decision of the Tokyo High Court seems to be in line, in my opinion, with the previous decisions outlined above (with the exception of the *Schneider* Case) and the view that the application of CFC legislation does not result in a violation of Article 7 of the OECD-MTC and that it is not required to explicitly stipulate the application of CFC legislation in the respective tax treaty. Moreover, it seems that the High Court, in general, considers the OECD-Commentary as an important tool for the interpretation of tax treaties irrespective of whether the OECD-Commentary is legally binding or not. In this respect, the understanding of the High Court seems to be close to the understanding of the Finnish Supreme Administrative Court in the *A Oyj Abp* Case.

7.2.6. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

Pursuant to the case law outlined above, the CFC rules can be applied without having been specifically preserved in the respective tax treaty. In fact, only the French Supreme Tax Court took a deviating position in the *Schneider* Case. Hence, based on the outcome of almost all of the cases discussed in this chapter the contracting states can apply the CFC rules to the income derived through another legal entity without violating the provisions and the principles of the underlying double tax convention. This means, at the same time, that these courts accepted the current taxation of income - and therefore the application of the principle of capital export neutrality - without the necessity of a vertical separation of the respective income. It can be understood, e.g. from the *A Oyj Abp* Case, that the current taxation should not be extended to “active businesses”, but it seems that this is just the quotation of the position outlined in the OECD-Commentary which suggests a separation based on the type of income - and therefore a horizontal separation. Hence, the case law does not restrict the states which follow the principle of capital export neutrality to the taxation of (only) specific parts of the underlying income. However, this is not in line with the position outlined in chapter 2 and chapter 3 which requires that the income taxation in the residence state of the shareholder should be limited to the basic interest component and should, therefore, not encompass income which is produced by the CFC[103] and income which is related to the risk which is directly covered by the CFC. Thus, despite the fact that I agree with the conclusion that there is no necessity to deal with the applicability of CFC legislation in the double tax conventions, the verifications show that the income should not solely be separated according to the type of income (horizontal separation), but it is required to follow a concept which also separates the income components within a certain type of income (vertical separation). From my perspective, it is therefore apparent that the case law - by

[102] Paragraph 10.1 of the Commentary on Article 7 of the OECD-MTC (2005) - which is, after the 2010 update, paragraph 14 of the Commentary on Article 7.

[103] Of course, the income which is produced by the CFC through a permanent establishment in the residence state of the shareholder shall be subject to tax in the latter state (according to the regular income tax system but not according to the concept of basic interest taxation).

accepting the application of the CFC rules in the tax treaty context - did not provide clear support for a less restrictive system which fosters competitiveness and which, at the same time, limits the application of the concept of capital export neutrality. The same is true for the *Schneider* Decision: the fact that the French Supreme Tax Court requires the stipulation of the application of CFC rules in the French tax treaties is not really a step forward. The decision is based on a position which is, in my opinion, not correct (and not in line with the outcome of the other cases) and which might even create an unnecessary obstacle for alternative concepts. A clear support would have been a decision which identifies the necessity of a vertical separation. However, this was not the case and, apparently, did not play any role regarding the question whether CFC rules are in line with tax treaties or not. At least, one of the conclusions from the case law (with the exception of *Schneider*) should be - for the moment - that there is, in principle, no obstacle from a tax treaty perspective for the application of a *different concept* which is based on the current taxation of the basic interest component. This, however, is quite an important conclusion. I will proceed with the test after the examination of the OECD perspective.

7.3. The Requirement of a Specific Preservation of CFC Rules in Double Tax Conventions

7.3.1. The OECD Perspective

Obviously, one of the decisive questions is whether the application of CFC rules must be specifically preserved in tax treaties or not. The amendments to the OECD Commentary in 1992 added specific reference to CFC legislation and a conflict seems to exist between paragraph 7 (added in 1977) and paragraphs 22-26 (added in 1992) of the Commentary on Article 1.[104] Paragraph 7 states that "*(t)he purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help tax avoidance or evasion. True, taxpayers have the possibility, irrespective of double taxation conventions, to exploit differences in tax levels between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter such manoeuvres. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws*."[105] This statement suggests that domestic anti-avoidance measures must be specifically preserved in tax treaties in order to remain effective.
In contrast thereto, the paragraphs added to the Commentary in 1992 give a different picture and suggest that certain anti-avoidance legislation is not within the ambit of a tax treaty and does not need to be confirmed in the treaty.[106] Paragraphs 22 to 25 of the Commentary state that *"(o)ther forms of abuse of treaties (e.g. the use of a base company) and of possible ways to deal with them such as "substance-over-form" and "sub-part F type" provisions have also been analysed.[107] The large majority of OECD*

[104] See in this respect also Portner, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International 2002, page 1679 et seq. (1682). See with respect to the question of the consistency of CFC legislation and tax treaties also the FEE Position Paper on Controlled Foreign Company Legislations in the EU, European Federation of Accountants, April 2002; Brähler, Controlled Foreign Companies-Rules, 2007, page 126 et seq.
[105] Paragraph 7 of the Commentary on Article 1 of the OECD-MTC (added in 1977).
[106] See in this respect also Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 89.
[107] Paragraph 22 of the Commentary on Article 1 of the OECD-MTC (added in 1992).

Member countries consider that such measures are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them. One could invoke the spirit of the Convention, which would be violated only if a company, which is a person within the meaning of the Convention, ended up with no or almost no activity or income being attributed to it, and the Contracting States took divergent views on the subject, with economic double taxation resulting therefrom, the same income being taxed twice in the hands of two different taxpayers (...). A dissenting view, on the other hand, holds that such rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use.[108] *It is not easy to reconcile these divergent opinions, either in theory or in mutual agreement procedures on specific cases. The main problem seems to be whether or not general principles such as "substance-over-form" are inherent in treaty provisions, i.e. whether they can be applied in any case, or only to the extent they are expressly mentioned in bilateral conventions. The dissenting view argues that to give domestic rules precedence over treaty rules as to who, for tax purposes, is regarded as the recipient of the income shifted to a base company, would erode the protection of taxpayers against double taxation (e.g. where by applying these rules, base company income is taxed in the country of the shareholders even though there is no permanent establishment of the base company there). However, it is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable.*[109] *While these and the other counteracting measures described in the reports mentioned in paragraph 11 above are not inconsistent with the spirit of the tax treaties, there is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties, as long as there is no clear evidence that the treaties are being improperly used. Furthermore, it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to avoiding double taxation. Where the taxpayer complies with such counteracting measures, it might furthermore be appropriate to grant him the protection of the treaty network.*"[110]

The Commentary outlines further in paragraph 26 (1992) that *"(t)he majority of Member countries accept counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, but believe that such measures should be used only for this purpose. It would be contrary to the general principles underlying the Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected. Counteracting measures should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer.*"[111]

[108] Paragraph 23 of the Commentary on Article 1 of the OECD-MTC (added in 1992).
[109] Paragraph 24 of the Commentary on Article 1 of the OECD-MTC (added in 1992).
[110] Paragraph 25 of the Commentary on Article 1 of the OECD-MTC (added in 1992).
[111] Paragraph 26 of the Commentary on Article 1 of the OECD-MTC (added in 1992).

The 1992 amendments to Article 1 of the Commentary are to a certain extent based on two OECD reports which were published in 1987.[112] It is therefore necessary to consider these reports in order to understand the substantial additions to the OECD Commentary. With respect to CFC legislation paragraph 43 of the base company report states that *"(u)nder existing counteracting measures, the country imposes a tax on residents who are shareholders in the foreign base company. The foreign company as such is not taxed; generally the income which gives rise to the taxation does not originate in the country of the base company but in the taxing country itself or in a third country. A tax treaty between the country using the counteracting legislation and the country of the base company usually protects, however, income flows only between these two countries. The first-mentioned country may therefore claim that the tax imposed under the counteracting legislation does not come under the scope of the said tax treaty."* Paragraphs 45 and 46 of the base company report state in part that *"(o)n the technical level, counteracting measures can attribute activities – and thus income – to a shareholder, which is not contrary to the tax treaties. If the counteracting measures have the effect of taxing a deemed dividend of the base company, this is well within the taxing rights conferred on the taxpayer's country of residence under the rules of tax treaties regarding taxation of dividends (...). On the tax policy level, counteracting measures pierce only the "umbrella effect" of the taxpayers' arrangements. This effect and the consequent possibilities for an independent deferral are not guaranteed by tax treaties which were never intended to prohibit national safeguards for the equity and neutrality of a country's tax law;"* and *"(o)n the international level, as long as some countries regard it as a sovereign right to shape their fiscal system in a way which might negatively affect other countries, tax authorities in these other countries must safeguard their sovereign right to preserve the equity and neutrality of their tax systems. It has never been intended that tax treaties would replace national sovereign rights with international co-operation to safeguard the integrity of tax systems.[113] It is evident that these are the views of States adopting counteracting measures and a very large majority of OECD Member countries have supported them (...)."* [114]

However, what remains is a possible conflict between paragraph 7 (1977) and paragraphs 22-26 (1992) of the Commentary on Article 1. Pursuant to *Sandler*, the reference in paragraph 7 of the Commentary may be restricted to domestic laws concerning the use of conduit companies and is therefore not equally true for the application of CFC rules.[115] This can be an explanation for the presumed conflict but it is not sufficiently clear from paragraph 7 itself. It is not unlikely that it has to be seen in the context of the following paragraphs which deal, *inter alia*, with the use of conduit companies. Paragraphs 11 to 21 contain a number of suggested treaty provisions related to conduit companies.[116] Thus, it makes sense to see the last sentence of paragraph 7 of the Commentary which states that *"(s)uch States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws"* in the context of the suggested treaty provisions contained in paragraphs 11 to 21 and not related to CFC

112 OECD, Double Taxation Conventions and the Use of Base Companies, 1987, and OECD, Double Taxation Conventions and the Use of Conduit Companies, 1987.
113 Paragraph 45 of the OECD base company report.
114 Paragraph 46 of the OECD base company report.
115 Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 89.
116 Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 89.

legislation. Another aspect which is of importance is the fact that the detailed amendments to the Commentary in 1992 only reflect the majority (and minority) opinion of the OECD Member countries and therefore the opinion of the respective tax administrations.[117] The position of the OECD itself is not stipulated in the Commentary (1992). The majority opinion cannot be the proper basis for the answer to the question whether the domestic CFC rules are in conflict with tax treaties - based on the OECD-MTC - or not.[118] The majority opinion of the Member countries can be wrong - comparable to the situation within the EU where the case law of the ECJ permanently shows that important domestic tax rules applied in the Member States violate the basic freedoms.[119]

The position of the OECD is now made clear in the amendments to the Commentary with effect as of January 2003.[120] The paragraphs related to CFC legislation do not refer to the majority (and minority) opinion anymore. Paragraphs 22.1 and 22.2 of the Commentary on Article 1 outline that the anti-abuse rules *"(...) are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule (...) there will be no conflict. For example, to the extent that the application of the rules referred to in paragraph 22 results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes.[121] Whilst these rules do not conflict with tax conventions, there is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused."*[122] The Commentary becomes very clear with respect to CFC rules in paragraphs 23 and 24 where it outlines that *"(t)he use of base companies may also be addressed through controlled foreign companies provisions. A significant number of Member and non-member countries have now adopted such legislation. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign companies legislation conflicted with these provisions. For the reasons explained in paragraphs 10.1 of the Commentary on Article 7 and 37 of the Commentary on Article 10, that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are read in their context.*

[117] Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (718); Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.
[118] See in this regard also Helminen in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, page 204 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 95.
[119] See in this respect Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (718); Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 95.
[120] See in this respect also Helminen, Is There a Future for CFC-regimes in the EU?, Intertax 2005, page 117 et seq. (118).
[121] Paragraph 22.1 of the Commentary on Article 1 of the OECD-MTC.
[122] Paragraph 22.2 of the Commentary on Article 1 of the OECD-MTC.

Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention.[123] *States that adopt controlled foreign companies provisions or the anti-abuse rules referred to above in their domestic laws seek to maintain the equity and neutrality of these laws in an international environment characterised by very different tax burdens, but such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer.*"[124] Without any doubt, the OECD takes the position that the domestic CFC rules can be applied without any clarification in the respective tax treaties since the CFC rules are not affected by the tax treaties and are not contrary to the treaty provisions. However, several countries made observations on the paragraphs 22 to 26 of the Commentary, such as Belgium, Ireland, Luxembourg, the Netherlands and Switzerland. I will come to the consequences of such observations below.[125]

7.3.2. Additional Aspects

The question remains whether the amendments to the Commentary in 1992 (which reflects only the majority and minority opinion of the OECD Member countries) and 2003 are of any significance for tax treaties concluded earlier. The outcomes of the *A Oyj Abp* Case and the *Schneider* Case are interesting in this respect: the CFC legislation of both countries follows an entity approach and neither the Finland-Belgium tax treaty nor the France-Switzerland tax treaty makes any specific reference to the domestic CFC legislation. Both treaties were concluded before the respective CFC legislation entered into force and both treaties were drafted along the general lines of the OECD-MTC and before the paragraphs with respect to CFC legislation were added to the Commentary in 1992.[126] The Finnish Supreme Administrative Court nevertheless considers the 1992 Commentary an auxiliary source of interpretation and states that *"(t)he wording of the Commentary which was in force when negotiations on the tax treaty in question were conducted lends particular weight to the interpretation but in the spirit of the Vienna Convention on the Law of Treaties, the amendments later made to the Commentary also have significance as an aid to interpretation. Similarly, as the Commentary describes the practices of the OECD member countries, the subsequent changes and amendments to it are relevant particularly to matters which concern new situations and phenomena. The positions gathered together in the Commentary indicate the generally accepted view of the OECD member countries as to the type of legislation which may be applied. According to the Commentary, national legislation must be applied in the spirit of the tax treaties*"[127] and *"(…) the Finnish CFC Act may be*

[123] Paragraph 23 of the Commentary on Article 1 of the OECD-MTC. The reference to paragraph 10.1 of the Commentary on Article 7 was replaced in the 2010 update by the reference to paragraph 14 of the Commentary on Article 7.
[124] Paragraph 26 of the Commentary on Article 1 of the OECD-MTC. The Paragraphs 24 and 25 have been deleted.
[125] See paragraphs 27.4 - 27.9 of the Commentary on Article 1 of the OECD-MTC.
[126] The Finland-Belgium tax treaty was concluded on June 18, 1976 and was supplemented on March 13, 1991. The amendments in 1991 did not concern the provisions which are relevant for the CFC legislation. The France-Switzerland tax treaty was concluded on September 9, 1966, and Article 7 (1) of the tax treaty was amended by the protocol signed on December 3, 1969.
[127] International Tax Law Reports (ITLR), Volume 4, 2002, page 1065.

applied nationally without this being prevented by the commitments entered into by Finland when concluding its tax treaty with Belgium nor by the way in which that treaty must be applied in accordance with the Vienna Convention on the Law of Treaties."[128] Moreover, the Court makes clear that *"(…) the fact that tax treaties concluded by certain countries may contain specific provisions on the acceptability of the application of CFC legislation does not mean that the conclusion to the contrary must be correct, namely that the applicability of CFC legislation is restricted in situations where the relevant tax treaty does not contain a provision explicitly permitting the application of such legislation.*"[129] In the French *Schneider* Case, the *Commissaire du Gouvernement* Austry outlines that *"(…) the commentaries of the OECD on art 1 of the Model Tax Convention state that the application of conventions should not facilitate tax avoidance or evasion. But these commentaries were formulated after the signing of the Franco-Swiss treaty, which prevents them from being used to clarify the meaning of this convention*."[130] The French Supreme Tax Court concludes that *"(e)ven assuming that it had been established that the objective of combating tax avoidance and evasion had been assigned to the Franco-Swiss treaty, this objective may not, in the absence of express provisions to that effect, derogate from the rules stated in the treaty*."[131] Thus, the legal position of the Finnish Supreme Tax Court and the French Supreme Tax Court is totally different with respect to the question whether the tax treaties have explicitly to provide for the application of the CFC rules, even though the circumstances of the cases are quite similar.

It is therefore far from clear that amendments to the Commentary can be used for the interpretation of tax treaties concluded earlier.[132] At least, the Supreme Tax Courts of some countries consider such an approach to be rather problematic.[133] In addition, the compatibility of CFC rules and tax treaties is still not clarified by the Supreme Tax Court in a substantial number of OECD and EU countries[134] and it is therefore solely the tax authorities' perspective which finds expression in the paragraphs added to Article 1 of the Commentary (1992).[135] The Vienna Convention on the Law of Treaties stipulates in Article 31 (1) and (2) of the Convention that *"(a) treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."*[136] And *"(t)he context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes: (a) any agreement relating*

[128] International Tax Law Reports (ITLR), Volume 4, 2002, page 1066.
[129] International Tax Law Reports (ITLR), Volume 4, 2002, page 1067.
[130] International Tax Law Reports (ITLR), Volume 4, 2002, page 1117.
[131] International Tax Law Reports (ITLR), Volume 4, 2002, page 1108.
[132] Lang, Das OECD-Musterabkommen - 2001 und darüber hinaus: Welche Bedeutung haben die nach Abschluss eines Doppelbesteuerungsabkommens erfolgten Änderungen des OECD-Kommentars?, Internationales Steuerrecht 2001, page 538.
[133] See Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (718); Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Michelsen in Lang, Tax Treaty Interpretation, 2001, page 72.
[134] See in this respect Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (718); Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 95; see also Portner, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International 2002, page 1679 et seq; Helminen, Is There a Future for CFC-regimes in the EU?, Intertax 2005, page 117 et seq. (118).
[135] That means, not sufficient case law exists which influences the position of the tax authorities.
[136] Article 31 (1) of the Vienna Convention on the Law of Treaties.

to the treaty which was made between all the parties in connection with the conclusion of the treaty; (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty."[137] There are different opinions in tax literature with respect to the question whether the OECD-Commentary forms part of the "context" for the purpose of the interpretation of a treaty.[138] A substantial number of commentators took the position that the Commentary could be part of the aforementioned "context" in those cases in which the contracting states follow the OECD-MTC, but this position seems to be restricted to the version of the Commentary which was existent at the time of conclusion of the tax treaty and cannot be transferred to changes or additions to the Commentary adopted after the conclusion of the tax treaty.[139] According to Vogel, Lang and Wassermeyer, the changes to the Commentary can, in general, only be relevant for the interpretation of tax treaties which were concluded after the respective changes were made.[140] In principle, Sandler takes the same position and points out that it would be inappropriate for a court to consider the Commentary introduced after the particular treaty was concluded.[141] This seems to be a logical approach, from my perspective, because it can be assumed that contracting states - when following the pattern of the OECD-MTC - also accept, at least in general, the interpretation of the OECD-MTC which is provided by the Commentary at the point in time of the conclusion of the treaty. I think it is even likely that the contracting states - by transferring the provisions of the OECD-MTC into a concrete tax treaty - wish to adopt a proper basis for the interpretation of the respective tax treaty (through the Commentary). However, it is apparent that this cannot be generally assumed for (perhaps very important) future changes or additions to the Commentary which are not known at the time of the conclusion of the respective tax treaty and which cannot (or can only partially) be influenced by the contracting states.

[137] Article 31 (2) of the Vienna Convention on the Law of Treaties. See with respect to CFC legislation and the Vienna Convention on the Law of Treaties also Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 54 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, page 142 et seq.

[138] See in this respect, *inter alia*, Wassermeyer in Debatin / Wassermeyer, Doppelbesteuerung, vor Art. 1, paragraph 41; Vogel in Vogel / Lehner, Doppelbesteuerungsabkommen, Einleitung, paragraph 125; Vogel, Klaus Vogel on Double Taxation Conventions, page 43 et seq.; Ault, The Role of the OECD Commentaries in the Interpretation of Tax Treaties, Essays on International Taxation, page 63; Engelen, Interpretation of Tax Treaties under International Law, 2004, page 439 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, page 126 et seq.

[139] See the overview and the references included in Engelen, Interpretation of Tax Treaties under International Law, 2004, pages 439-473. According to Avery Jones, it is unlikely that the Commentaries should be accorded the status of a mere supplementary means of interpretation, precisely because, in the absence of any indication to the contrary, it must be assumed that the parties to a treaty that corresponds to the OECD-MTC intended the treaty to be interpreted in accordance with the Commentaries thereon. However, Avery Jones also takes the view that changes or additions to the Commentary adopted after the conclusion of the treaty are clearly not in the same category (see Engelen, Interpretation of Tax Treaties under International Law, 2004, pages 446, 447; Avery Jones, The Effect of Changes in the OECD Commentaries after a Treaty is Concluded, Bulletin for International Fiscal Documentation 2002, pages 102-104).

[140] Vogel / Lehner, Doppelbesteuerungsabkommen, Einleitung, paragraph 127; Lang, Seminar B, Teil 2: Das OECD-Musterabkommen - 2001 und darüber hinaus: Welche Bedeutung haben die nach Abschluss eines Doppelbesteuerungsabkommens erfolgten Änderungen des OECD-Kommentars?, Internationales Steuerrecht 2001, page 536 et seq. (538); see also Lang, The Application of the OECD Model Tax Convention to Partnerships, 2000, page 20; Wassermeyer in Debatin / Wassermeyer, Doppelbesteuerung, vor Art. 1, paragraph 60). See with respect to similar positions also Michelsen in Lang, Tax Treaty Interpretation, 2001, page 63 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 98.

[141] Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 83.

Article 31 (3) of the Convention states that *"(t)here shall be taken into account, together with the context: (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) any relevant rules of international law applicable in the relations between the parties.*"[142] Here, it must be concluded that a subsequent amendment to the OECD-MTC or to the Commentary cannot be seen as a subsequent agreement or a subsequent practice in the application of the respective tax treaty.[143] In other words, such a subsequent agreement or a subsequent practice must be directly related to the respective tax treaty (and not to the OECD-MTC or the Commentary). Thus, the general rules of interpretation stipulated in Article 31 of the Convention do not support, in my opinion, the position that amendments to the OECD-MTC or to the Commentary have an influence on tax treaties concluded earlier. Article 32 of the Convention refers to supplementary means of interpretation. If the Commentary can be considered part of the preparatory work of the respective tax treaty, then it should be the version which was applicable at the time of conclusion of the respective tax treaty.[144] In addition, the supplementary means of interpretation according to Article 32 of the Convention are relevant only if the interpretation according to Article 31 of the Convention *"(a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable*."[145]

In my opinion, a subsequent amendment to the OECD-MTC or to the OECD-Commentary cannot be used for the interpretation of a tax treaty which was concluded earlier - even if the tax treaty strictly follows the lines of the OECD-MTC.[146] Based on the position outlined above, the subsequent amendments are not part of the "context" which is referred to in Article 31 (2) of the Vienna Convention on the Law of Treaties.[147] With respect to CFC legislation, the 1992 amendments are not, in

[142] Article 31 (3) of the Vienna Convention on the Law of Treaties.
[143] See also Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (718); Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 98; Wassermeyer in Mössner / Blumenwitz et al., Doppelbesteuerungsabkommen und nationales Recht, 1995, page 85 et seq.; Vogel in Vogel / Lehner, Doppelbesteuerungsabkommen, Einleitung, paragraph 125.
[144] See the references outlined above. Regarding the question whether the OECD-MTC and / or the OECD-Commentary can be considered preparatory work of the respective treaty in the sense of Article 32 of the Vienna Convention on the Law of Treaties see Mössner, Festschrift Seidl-Hohenveldern, pages 411, 412, fn. 54 (can be considered preparatory work); Prokisch, Steuer und Wirtschaft International 1994, page 53; Vogel / Prokisch, Die Auslegung von Doppelbesteuerungsabkommen, page 19 et seq. (31); Vogel in Vogel / Lehner, Doppelbesteuerungsabkommen, Einleitung, paragraph 125 (cannot be considered preparatory work).
[145] Article 32 of the Vienna Convention on the Law of Treaties.
[146] See in this respect also Vogel in Vogel / Lehner, Doppelbesteuerungsabkommen, Einleitung, paragraph 127. This should also be true for mere "clarifications" (see Vogel, paragraph 129).
[147] The question regarding the relationship between Article 3 (2) of the OECD-MTC and Articles 31 and 32 of the Vienna Convention on the Law of Treaties (VCLT) might come up. In this respect, it seems to be the prevailing view in tax literature that the rules of interpretation included in Articles 31 and 32 of the VCLT are also relevant for the interpretation of Article 3 (2) of the OECD-MTC and that Article 3 (2) of the OECD-MTC is to be seen as a *lex specialis* in relation to Articles 31 and 32 of the VCLT for the interpretation of the provisions of the respective tax treaty (see Vogel / Lehner, Doppelbesteuerungsabkommen, Article 3, paragraph 120; Engelen, Interpretation of Tax Treaties under International Law, 2004, pages 477-479). However, the definition of the "context" in Article 31 (2) of the VCLT is, in my opinion, not relevant for the interpretation of the provisions of the respective tax treaty according to Article 3 (2) of the OECD-MTC (see also Vogel / Lehner, Ibid., paragraph 121). Thus, the conclusion that the subsequent amendments to the OECD-MTC and / or the

my opinion, sufficiently clear to be used for the interpretation of tax treaties.[148] However, the 2003 amendments provide a clear picture of the position of the OECD and are therefore of particular relevance for tax treaties which are based on the OECD-MTC and which were concluded in 2003 and subsequent years. Based on this position, there is no necessity whatsoever to preserve the CFC taxation in tax treaties. In this respect, the Finnish Supreme Administrative Court should not have referred to the 1992 Commentary as an auxiliary source of interpretation since the Finland-Belgium tax treaty was concluded earlier. This does not mean, though, that the outcome of the case is "wrong" (from my perspective), but the argumentation should not have been based on the amended version of the Commentary.

Thus, if one agrees with the aforementioned position, it seems to be consistent that any observations of one of the treaty partners on *subsequent* amendments to the Commentary do not affect the existing tax treaty (and the interpretation of the tax treaty). That means the observations of Belgium on Article 1 - with respect to CFC legislation (2003 amendments)[149] - do not have any impact on the existing tax treaty between Belgium and Finland (which was concluded earlier). Hence, if the Finnish Administrative Court would have had to decide (theoretically) the *A Oyj Abp* Case in 2003, there should still be no reference to the amended version of the Commentary and the observations of the treaty partner. However, the question arises whether the observations of Belgium would have any impact on a tax treaty concluded in 2003 (or later), i.e. after the amendment and the observations. In this case, it is important to note that the Commentary explicitly deals with the question of CFC legislation in the light of the OECD-MTC *and*, in addition, one of the contracting states does not agree with this position (by making observations on the respective paragraphs). In such a situation, it seems to be essential that the contracting states, Finland and Belgium, explicitly deal with the question of the application of CFC rules in their relationship, either in the tax treaty itself or in the agreements or instruments which are referred to in Article 31 (2) (a) and (b) of the Vienna Convention on the Law of Treaties. If the tax treaty is based on the OECD-MTC, it has to be made sufficiently clear if the parties intend to deviate from the position of the OECD.[150] However, if the parties do not deal with this question at all, this will not have the effect that the observations of Belgium are part of the tax treaty (and the context). At least, this is true if one follows the position that the Commentary (and the observations) do not form part of the context which has to be taken into account pursuant to the aforementioned Article 31 (2) of the Convention. On the other hand, if one agrees that the Commentary forms part of the context within the meaning of Article 31 (2) of the Convention, this will also encompass the observations of Belgium and should therefore theoretically be considered by the contracting states. Thus, the 2003 amendments to the Commentary, and the position of the OECD with respect to CFC legislation, cannot simply be used for the interpretation of a new (or revised) tax treaty because of the observations made by one of the contracting states.[151] Nonetheless, this does not change the conclusion with respect to the question whether the application of the CFC rules must be specifically preserved in a tax treaty or not. In my opinion, it is not

OECD-Commentary are not part of the "context" which is referred to in Article 31 (2) of the VCLT will not be changed by the existence of Article 3 (2) of the OECD-MTC.

[148] See in this respect also Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 99.

[149] See paragraph 27.4 of the Commentary on Article 1 of the OECD-MTC (2003). This is unchanged in the 2010 update.

[150] See in this respect Wassermeyer in Debatin / Wassermeyer, Doppelbesteuerung, vor Art. 1, paragraph 41.

[151] See in this respect also Vogel in Vogel / Lehner, Doppelbesteuerungsabkommen, Einleitung, paragraph 130.

necessary to explicitly refer to CFC rules in a tax treaty in order to be applicable. The CFC rules are part of the domestic legislation of the contracting state(s) and there is, in principle, no reason why those rules should be treated differently (from other domestic rules) in order to be applicable in a tax treaty context. In other words, if CFC rules shall not be applied in the relationship between the contracting states, this fact must be explicitly stipulated in the tax treaty and cannot just be derived from the observations to the Commentary.

Another aspect which is of importance is the fact that the Commentary refers to measures against abuse (or counteracting measures). Clearly, CFC legislation is to be seen as an anti-avoidance legislation which counteracts the deferral of income in low-tax countries. However, it is quite obvious to me that CFC rules not only affect structures which are abusive but can in the same way affect regular business activities. The system of CFC taxation does not make any clear separation between abusive and non-abusive activities since the focus is much too broad for such a separation. The outcome is a general application of those rules to certain income components which are taxed at a lower rate than the comparable income in the state of the shareholder. Thus, the CFC rules can be seen as an important tool against domestic tax base erosion caused by abusive *and non-abusive* relocations of activities. Therefore, even if the general aim of a double tax convention encompasses, *inter alia*, the combating of international tax avoidance and tax evasion, this cannot result in an unrestricted application of CFC rules *outside* the limitations provided by a double tax convention. That means, if the residence state of the shareholder stipulates, in the context of the domestic CFC legislation, a link to the income which is derived by the shareholder through a CFC interposed in the other contracting state, it is required to examine the latter income and to determine the type of income in the light of the respective tax treaty - from the perspective of the residence state of the shareholder. Hence, the income derived through the CFC is to be examined not only from the perspective of the residence state of the CFC (related to the CFC itself), but it is also to be examined from the perspective of the residence state of the shareholder (related to the shareholder) which has established such a link in the domestic CFC legislation. If the income classification leads to the outcome that the state of residence of the shareholder has the right to tax the income of the shareholder under the respective tax treaty, there is, in principle, no restriction for the application of the domestic CFC legislation. In contrast thereto, if the income classification leads to the outcome that the state of residence of the shareholder does not have the right to tax the income of the shareholder under the respective tax treaty, the application of the domestic CFC legislation would result in a tax treaty override.

7.3.3. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The examination shows that the OECD perspective is in line with the outcome of the case law outlined earlier (with the exception of the *Schneider* Case). Although this is not really a big surprise - given the fact that the OECD perspective was in some of the cases the basis for the decision - it confirms, in my opinion, that an approach which focuses on the taxation of the basic interest component in the residence state of the shareholder is not in conflict with the respective double tax convention. At least, this is true as long as the double tax convention does not explicitly exclude the application of such a system. It has always to be kept in mind that the concept of the taxation of the basic interest component is less restrictive - compared to the typical CFC regimes which were outlined in chapter 6 - and neither taxes the income produced by the CFC nor the income which is related to the compensation of risks.[152] In other words, what was concluded with respect to the application of CFC rules should also be true for the application of an alternative legislation which is based on the concept of the taxation of the basic interest component.

7.4. CFC Income in the Context of the OECD Model Tax Convention

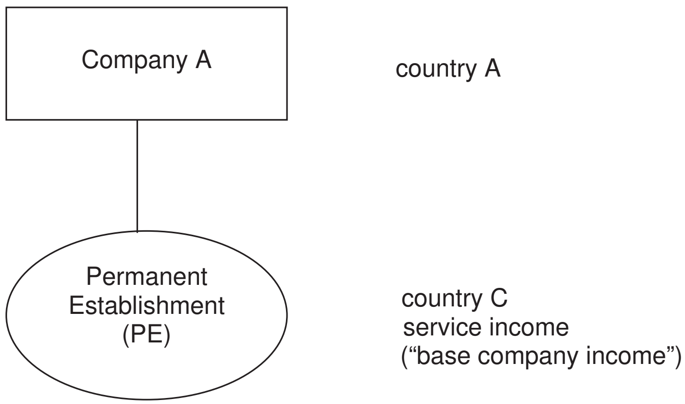
The number of cases which deal with the classification of attributable income pursuant to CFC rules is still too limited in order to identify a strong tendency towards a particular type of income. However, it is remarkable, in my opinion, that in none of the decisions outlined above the income was classified as dividend income from a tax treaty perspective. On the other hand, the classification as business income is sometimes not clear enough or not "convincing" enough. For example, the Court of Appeal in the *Bricom Holdings* Case did not deal with this question explicitly and it remains unclear whether the "chargeable profits" might be seen as business profits of the shareholder. In the *Captive Insurance* Cases the Swedish Council for Advance Rulings classified the income as business profits, but the alternative reference to a classification as other income reveals some uncertainty. Moreover, the OECD-Commentary does not determine a particular type of income, either. It remains open whether the income of the shareholder is to be classified as business income, dividend income, or other income. For this reason, it is necessary to examine the classification of the income which is attributable to the shareholder in some more detail.[153]

7.4.1. Article 7 of the OECD Model Tax Convention

In the following, the verification of the type of income in the context of the OECD-MTC will focus on situations which are of great importance within a multinational group of companies: a CFC situated in a low-tax country which provides services to other group companies. However, it may be helpful to start with the situation of a PE and, subsequently, to compare the outcome with the taxation of CFC income related to a foreign legal entity situated in another country.

[152] As long as the income produced by the CFC is not connected to a permanent establishment in the residence state of the shareholder, there will be no income taxation in the latter state. Of course, even in case of a permanent establishment the income produced by the CFC would not be taxed under the basic interest taxation regime but according to the regular income tax regime.
[153] See with respect to the classification of CFC income under double tax conventions also Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq.; Aigner, Die Abkommensberechtigung bei Anwendung einer CFC-Gesetzgebung, Internationale Wirtschafts-Briefe 2002, page 1637 et seq.; Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq.; Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Portner, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International 2002, page 1679 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 103 et seq.

Figure 1:

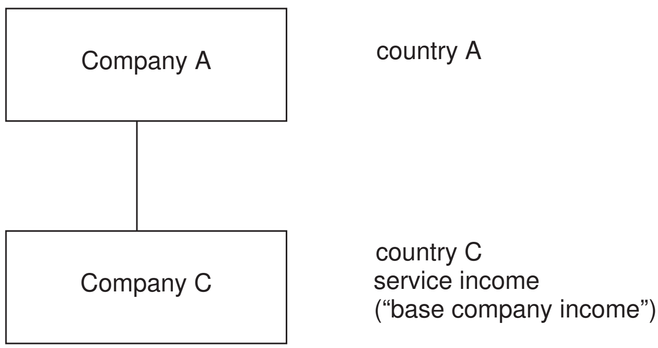


In this example, company A (resident in country A) carries on activities through a PE in country C. The activities of the PE can be seen as "base company activities" (in order to use the terminology applied in the context of CFC legislation),[154] i.e. the providing of services towards other group companies, e.g. in country B.[155] The services do not encompass financing, rental and licensing activities. Article 7 (1) of the OECD-MTC states that *"(t)he profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State*." Thus, the income allocable to the PE in country C may be taxed in the latter country. However, the wording "*may be taxed in that other State*" still provides for the possibility of a taxation of the income in country A.[156] This, however, would lead to a taxation of the same income (the "base company income") in the hands of the same person (company A) by more than one state - and therefore to a juridical double taxation of income.[157] In such a case, the state of residence (country A) must give relief so as to avoid the juridical double taxation.[158] The double taxation can be avoided by the exemption method[159] or the credit method.[160] In general - and with respect to the underlying example - there is no preference whatsoever for one of the two methods.[161] The question whether the residence

[154] "Base company activities" are, of course, typically related to a foreign legal entity and not to a PE. However, a PE can perform activities which are comparable to such base company activities.
[155] As already outlined earlier, the provision of services towards other group companies can be one of the reasons why the income derived from these activities can be subject to CFC taxation. However, legally it is quite clear that the services are provided by company A - since the PE is from a legal perspective a non-separable part of company A. Nonetheless, the functions exercised in the PE country require - from a tax point of view - the allocation of income to the PE.
[156] In contrast to the wording "shall be taxable only" (see in this respect paragraph 6 of the Commentary on Article 23 A and 23 B of the OECD-MTC).
[157] See paragraph 1 of the Commentary on Articles 23 A and 23 B of the OECD-MTC.
[158] See paragraph 7 of the Commentary on Articles 23 A and 23 B of the OECD-MTC.
[159] Article 23 A of the OECD-MTC.
[160] Article 23 B of the OECD-MTC.
[161] See also paragraph 28 of the Commentary on Article 23 A and 23 B of the OECD-MTC.

country applies the exemption method or the credit method is strongly connected to the question whether the country follows the principle of capital import neutrality or capital export neutrality. However, even in cases where the resident country applies the exemption method as the general principle for the avoidance of double taxation of business income derived in the PE country, it is often considered necessary to switch-over from the exemption method to the credit method under certain circumstances. Here, we come close to the concept of CFC taxation. For example, the majority of tax treaties concluded by Germany contain activity clauses which lead to a switch-over from the exemption method (the main principle) to the credit method in case of certain passive income derived by the PE.[162] In addition, the German Income Tax Act and the German Foreign Tax Act contain provisions which lead to an application of the credit method even though the exemption method is included in the respective tax treaty[163] and which limit the offsetting of negative PE income.[164] The application of the credit method results in the PE income being calculated (i) according to the rules of the residence country A and (ii) according to the rules of the PE country. The residence country A subsequently provides for an ordinary tax credit of the income taxes imposed in country C on the underlying income. The PE example is quite clear, at least where the income is derived from business activities in the PE country. In general, the same principles apply to business income which is derived by the PE (and allocable to the PE) but which is related to the residence country.[165]

Figure 2:



The example is now amended in a way that the PE in country C is replaced by a separate legal entity (company C). This, of course, changes the situation - at least from a tax treaty perspective - considerably. Now, there are two resident companies involved: company A as a resident of country A, and company C as a resident of country C. Both companies are liable to tax in their respective countries of residence. The profits of company A *"(...) shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent*

162 See in this respect Vogel, Doppelbesteuerungsabkommen, Article 23, paragraph 74 et seq.
163 See section 20 (2) of the German Foreign Tax Act - which has the effect of a treaty override.
164 See section 2 a of the German Income Tax Act.
165 Paragraph 9 of the Commentary on Articles 23 A and 23 B of the OECD-MTC. In the example, this can be related to other companies resident in country A but not to company A itself (since the PE is legally a part of the resident company A).

establishment situated therein."[166] Company A has no *direct* business activities in country C but only *indirect* business activities through the participation in company C which carries on base company activities. The question arises whether the participation is to be considered a PE. Pursuant to Article 5 (1) of the OECD-MTC *"(...) the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on*." Article 5 (7) of the OECD-MTC is clearer in this respect and stipulates that *"(t)he fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not itself constitute either company a permanent establishment of the other."* It is outlined in the Commentary that *"(...) the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.*"[167] Therefore, a subsidiary company may constitute a PE of the parent company under the conditions stipulated in Article 5 (5) of the OECD-MTC - as any other unrelated party - but not because of the mere existence of control.[168] In the example, the fact that the subsidiary company C carries on base company activities towards company B - or even towards the parent company A - does not lead to the result that the subsidiary company C constitutes a PE of the parent company A. On the other hand, the subsidiary company C - as a resident taxpayer of country C - derives base company income which shall be taxable only in state C unless the enterprise carries on business in the other state through a permanent establishment situated therein.[169] The latter is - according to the example and based on the aforementioned arguments - not the case. The business activities of company C are carried on in country C and even though the services are directed towards other countries, there is no sufficient nexus to those countries in order to constitute a PE. Thus, the business income derived from the base company activities is taxable only in country C.

As a preliminary conclusion it can be stipulated that the business profits derived by company A shall be taxable in country A, and the business profits derived by company C shall be taxable in country C - based on Article 7 (1) of the OECD-MTC. Neither company A nor company C constitute a PE in the other country. However, additional questions come up with the application of the CFC rules of country A, i.e. where the income related to the base company activities is not only subject to tax in country C but is also in the focus of the CFC rules of country A. In principle, the CFC income which is defined by the domestic legislation of country A is taxable in the latter country - based on Article 7 (1) - if the income is not allocable to a PE. It was outlined above that the subsidiary company C does not constitute a PE of company A. However, the CFC rules typically refer to the income derived by the foreign legal entity. It may even be the case that the amount of CFC income determined pursuant to the CFC rules of country A is completely identical to the taxable income of the

[166] Article 7 (1) of the OECD-MTC.
[167] Paragraph 40 of the Commentary on Article 5 of the OECD-MTC; see in this respect also Vogel, Doppelbesteuerungsabkommen, Article 5 (7), paragraph 165 et seq.
[168] See also paragraph 41 of the Commentary on Article 5 of the OECD-MTC.
[169] Article 7 (1) of the OECD-MTC.

subsidiary company determined in country C.[170] Nonetheless, both countries separately determine the facts which give rise to a tax liability. The fact that country A stipulates a nexus to income elements derived by another legal entity in country C is, by itself, not particularly problematic. Country A is basically free to do so and is - in general - not restricted by the tax treaty between the countries A and C.[171] Tax treaties allocate taxing rights to the contracting states but do not directly affect the structuring of domestic legislation. In effect, the base company income is - from an economic perspective - subject to tax in country C and, in addition, in country A. This leads to an economic double taxation of income in the hands of two different taxpayers, namely company C (which is a resident of country C) and company A (which is a resident of country A). Clearly, this is one of the significant differences to the example outlined above with respect to the PE, where a juridical double taxation was involved. It was already outlined earlier that the avoidance of economic double taxation - in contrast to juridical double taxation - is not within the scope of a tax treaty. This is what the French Supreme Tax Court did not accept in the *Schneider* Case. However, it cannot be ignored - in my opinion - that there are two separate taxpayers involved which are resident in two different states. And even though it can be argued that there is - from an economic perspective - an "*identity of nature*"[172] between the base company income derived by company C and the CFC income allocable to company A, the outcome under the respective tax treaty has to be verified separately and from the perspective of both states. *Lang* compares the situation with the taxation of a partnership where a qualification conflict exists: one of the contracting states taxes the partnership (as a non-transparent entity) and the other state taxes the partners (because the partnership is considered to be transparent). It is the perspective of the respective state which leads to the double taxation - and it cannot be said that one of the two positions is wrong.[173]

However, the question remains whether the CFC income is to be seen as "business profits of an enterprise" in the sense of Article 7 of the OECD-MTC. It should be clear that company A is an "enterprise of a Contracting State."[174] Pursuant to Article 3 (1) letter h the term "business" includes the performance of professional services and of other activities of an independent character.[175] However, the base company activities themselves are *directly* carried on by company C and not by company A. Nonetheless, the allocation decision of country C is – in my opinion – not binding for the other contracting state, i.e. country A may still determine the income as business

[170] In cases where the whole income is subject to CFC taxation and where the income determination rules in both countries are to a large extent identical.
[171] See in this respect Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (723); Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Lang in IFA, Abusive Application of International Tax Agreements, 2001, page 24. However, see the position of Vogel, Klaus Vogel on Double Taxation Conventions, 1990, paragraph 125 and Schwarz, Controlled Foreign Companies and Tax Treaties, Bulletin for International Fiscal Documentation 1997, page 553 et seq.
[172] See in this respect the French Supreme Tax Court in the *Schneider* Case which was outlined earlier.
[173] Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (720).
[174] Article 3 (1) letter c and d of the OECD-MTC.
[175] Article 3 (1) letter h of the OECD-MTC; moreover, paragraph 71 of the Commentary on Article 7 of the OECD-MTC outlines that *"(a)lthough it has not been found necessary in the Convention to define the term "profits," it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries."*

income allocable to the resident company A.[176] Country A has to apply the tax treaty from its own perspective and the general definitions in Article 3 of the OECD-MTC do not provide for an exhaustive definition of the term "business profits" which – from the perspective of country A – leads to the result that the definition included in its domestic law has to be referred to.[177] However, the verification must be concentrated on the actual activities, i.e. the service activities, and not on the mere domestic categorisation of CFC income itself.[178] The latter is not decisive in the tax treaty context.[179] Therefore, the activities carried on in country C have to be verified from the perspective of country A with reference to its domestic law.[180] If it turns out that the income derived from these activities is to be qualified as "business profits," the income which is allocable to the resident company A according to the domestic CFC rules may be taxed in country A pursuant to Article 7 (1) of the OECD-MTC – due to the fact that no permanent establishment exists in country C. The Commentary on Article 7 (1) of the OECD-MTC states in this respect that *"(t)he purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (…)."*[181] In my opinion, the above examination shows that there are clear arguments in favour of a qualification of the attributed CFC income as business profits of the shareholder according to Article 7 (1) of the OECD-MTC. In

[176] See also Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (720); however, according to Portner, Article 7 does not draw a distinction whether it is the business of the foreign enterprise or the business of the foreign company's domestic shareholder, and therefore Article 7 should be respected if the CFC rules apply (Portner, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International 2002, page 1679 et seq. (1690)).

[177] Hemmelrath in Vogel / Lehner, Doppelbesteuerungsabkommen, 2003, Article 7, paragraph 21; Piltz in Debatin / Wassermeyer, Musterakommen, Article 7, paragraph 73; Schaumburg, Internationales Steuerrecht, 1998, paragraph 16.228; Kroppen in Becker / Höppner / Grotherr / Kroppen, DBA, Article 7, paragraph 42.

[178] For example, the CFC income attribution may generally be qualified under the domestic legislation of the country which applies the CFC rules as – for example – dividend income or income from capital. However, this does not lead to the outcome that the income is necessarily considered to be dividend income in the tax treaty context, too. What is important here is the general definition of "business profits" under domestic law and not the categorisation of CFC income. If the income derived from the foreign activities fulfils the domestic requirements of business profits, it is also to be qualified as business profits in the tax treaty context.

[179] See in this respect also Vogel, Doppelbesteuerungsabkommen, Article 10, paragraph 223.

[180] See in this respect also the Finnish Supreme Tax Court in the *A Oyj Abp* Case: "*When (…) the type of activity carried out by A Finance NV and its significance to A are taken into consideration and when account is taken to art 1 of the Business Income Tax Act, A's income undoubtedly, on the basis of the CFC Act, falls within the category of business income according to the Finish domestic legislation*" (see ITLR, Volume 4, 2002, pages 1062, 1063). When verifying the income in the light of the tax convention, the Finnish Supreme Tax Court states that *"(a)ccording to the Commentary to art 7 of the OECD Model Tax Convention, the concept of business income referred to in the Commentary is to be broadly understood and comprises all income derived from trading activities. Article 7 of the tax treaty between Finland and Belgium conforms to the OECD Model. It has already been noted above that the character of the income of the controlled foreign company is that of business income and base company income for the purposes of national law. When determining the character of the same income for the purposes of the tax treaty, the starting point must be that this income constitutes business income under art 1 of the Business Income Tax Act and the tax treaty does not contain any definition of business income, such a definition being derived from national law. Hence, for the purpose of applying the tax treaty, the income has the character of business income*" (see ITLR, Volume 4, 2002, pages 1067, 1068).

[181] Paragraph 14 of the Commentary on Article 7 of the OECD-MTC.

this case, one can follow the statement of Sandler - made as final remarks after an examination of the jurisprudence in CFC cases - that the only issue of consequence for the court in a CFC case should be the determination whether the respective double tax convention is limited to juridical double taxation or whether it encompasses also economic double taxation.[182] This, in essence, would be the decisive point for the answer to the question whether the state of residence of the shareholder has the right - under the double tax convention - to tax the attributed income or not.

However, it should be noted that Article 7 (4) of the OECD-MTC gives first preference to the special articles - for example - on dividends, interest and royalties. Thus, Article 7 of the OEC-MTC will be applicable to business profits which do not belong to categories of income covered by the special articles.[183] The result of the aforementioned examination might be different where dividend income, interest income or royalty income is included in the attributable CFC income. This will be verified below. Moreover, it has to be examined whether the CFC income attribution has to be seen - in general - as a dividend distribution of the CFC itself rather than an attribution of business income. If this is the case, Article 10 of the OECD-MTC would have preference over Article 7 of the OECD-MTC.[184]

7.4.2. Article 10 of the OECD Model Tax Convention

It is quite obvious that the CFC income allocation has to be verified in the context of Article 10 of the OECD-MTC. There are a number of commentators who consider the CFC income to be “dividend income” in the light of the OECD-MTC.[185] Pursuant to Article 10 (3) of the OECD-MTC the term “dividends” means *“(…) income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income*

[182] Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 215. However, it has to be added that the remarks were made prior to the decision of the Conseil d’Etat in the Schneider Case and prior to the decision of the Supreme Administrative Court in the A Oyj Abp Case.

[183] Article 7 (4) of the OECD-MTC; see also paragraph 74 of the Commentary on Article 7 of the OECD-MTC.

[184] See in this respect also Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq. (412). See with respect to the position that the CFC income can be considered business income from a tax treaty perspective: Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, pages 182, 183; Kabbaj / Raingeard de la Bletière, National Report France, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, pages 241-244. Noguera / Streichen, National Report Luxembourg, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, pages 423, 424. However, see also the dissenting position of Brähler in Brähler, Controlled Foreign Companies-Rules, 2007, page 171.

[185] See the references in Vogel, Doppelbesteuerungsabkommen, Article 10, paragraph 224; see also Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (721); Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq.; Aigner, Die Abkommensberechtigung bei Anwendung von CFC-Gesetzgebungen, Internationale Wirtschafts-Briefe 2002, page 1637 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 103 et seq.; Helminen, National Report Finland, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, page 212 (dividend income or other income); Brähler, Controlled Foreign Companies-Rules, 2007, page 171 et seq. Brähler examines the “Zurechnungstheorie”, “Ausschüttungstheorie” and “Repräsentationstheorie” and comes to the conclusion that one should follow the “Ausschüttungstheorie” (and therefore Article 10 of the OECD-MTC) in the tax treaty context; see also the various arguments outlined in Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 96 et seq.

from shares by the laws of the State of which the company making the distribution is a resident."[186] Of course, the enumeration is by no means concluding.[187] In addition, payments regarded as dividends may also include other benefits in money or money's worth, as well as disguised distributions of profits.[188] Paragraph 38 of the Commentary on Article 10 of the OECD-MTC refers to CFC legislation and outlines that *"(…) such legislation or rules may, however, complicate the application of Article 23. If the income were attributed to the taxpayer then each item of the income would have to be treated under the relevant provisions of the Convention (business profits, interest, royalties). If the amount is treated as a deemed dividend then it is clearly derived from the base company thus constituting income from that company's country. Even then, it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 or as "other income" within the meaning of Article 21. Under some of these legislation or rules the taxable amount is treated as a dividend with the result that an exemption provided for by a tax convention, e.g. an affiliation exemption, is also extended to it. It is doubtful whether the Convention requires this to be done. If the country of residence considers that this is not the case it may face the allegation that it is obstructing the normal operation of the affiliation exemption by taxing the dividend (in the form of a "deemed dividend") in advance.*"[189] The Commentary also goes into detail regarding possible problems related to the combination of current attribution of CFC income and subsequent dividend payment of the foreign company: *"(w)here dividends are actually distributed by the base company, the provisions of a bilateral convention regarding dividends have to be applied in the normal way because there is dividend income within the meaning of the convention. Thus, the country of the base company may subject the dividend to a withholding tax. The country of residence of the shareholder will apply the normal methods for the elimination of double taxation (i.e. tax credit or tax exemption is granted). This implies that the withholding tax on the dividend should be credited in the shareholder's country of residence, even if the distributed profit (the dividend) has been taxed years before under controlled foreign companies legislation or other rules with similar effect. However, the obligation to give credit in that case remains doubtful. Generally the dividend as such is exempted from tax (as it was already taxed under the relevant legislation or rules) and one might argue that there is no basis for a tax credit. On the other hand, the purpose of the treaty would be frustrated if the crediting of taxes could be avoided by simply anticipating the dividend taxation under counteracting legislation. The general principle set out above would suggest that the credit should be granted, though the details may depend on the technicalities of the relevant legislation or rules and the system for crediting foreign taxes against domestic tax, as well as on the particularities of the case (e.g. time lapsed since the taxation of the "deemed dividend"). However, taxpayers who have recourse to artificial arrangements are taking risks against which they cannot fully be safeguarded by tax authorities.*"[190]

The definition of the term "dividends" in Article 10 (3) of the OECD-MTC requires the focus on the classification of the state of the company which makes the distribution (source state). However, this should be true where the source state *positively* classifies certain types of income as (regular) dividend income, but this should not

[186] Article 10 (3) of the OECD-MTC.
[187] See paragraph 23 of the Commentary on Article 10 of the OECD-MTC.
[188] See paragraph 28 of the Commentary on Article 10 of the OECD-MTC.
[189] Paragraph 38 of the Commentary on Article 10 of the OECD-MTC.
[190] Paragraph 39 of the Commentary on Article 10 of the OECD-MTC.

mean that a *negative* classification is equally binding for the residence state of the shareholder.[191] Thus, if certain types of income cannot be classified as dividend income in the state of source, the state of residence of the shareholder has to make an autonomous examination in the light of the tax treaty.[192] In any event, the domestic legislation of the residence state of the shareholder is not decisive for the classification of income as dividend income.[193] In this respect, it seems that the definition in Article 10 (3) of the OECD-MTC not only encompasses the distributions decided by the shareholders' meeting but also, for example, hidden distributions of profit which do not necessarily require an actual outflow of financial means from the company to the shareholder.[194] At least, the foreign companies which are typically in the focus of CFC rules are companies pursuant to Article 3 (1) letter b, namely "*any body corporate or any entity that is treated as a body corporate for tax purposes*" and it is the qualification of the residence state of the company which is decisive in this respect.[195] However, the fact that the profit distributions of the foreign entities are "dividends" in the sense of Article 10 (3) does not - in my opinion - necessarily lead to the conclusion that the CFC income attribution leads to "income from shares" (dividend income).[196] Of course, the reference to hidden distributions of profit shows that dividend income does not necessarily require an actual transfer of financial means from the company to the shareholder. However, the situation of a hidden distribution of profit is - in my opinion - by no means comparable to the income attribution according to CFC rules. In case of a hidden distribution of profit, the company typically gives away a certain value in favour of the shareholder. This can either lead to an immediate reduction of the net asset value or to a situation where the company cannot increase the net asset value since it gives away the possibility to increase the net asset value in favour of the shareholder.[197] In any case, it is a

[191] Vogel, Doppelbesteuerungsabkommen, Article 10, Rz. 223.
[192] Vogel, Doppelbesteuerungsabkommen, Article 10, Rz. 223.
[193] This, of course, is also true if one takes the position that the positive and negative classification of the state of source is decisive (and not only the positive classification).
[194] Paragraph 28 of the Commentary on Article 10 of the OECD-MTC; see also Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht, 2002, page 717 et seq. (721); Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq. (413); see also Aigner, Die Abkommensberechtigung bei Anwendung einer CFC-Gesetzgebung, Internationale Wirtschafts-Briefe 2002, page 1637 et seq.; Tischbirek in Vogel / Lehner, Doppelbesteuerungsabkommen, Article 10, paragraph 203; Wassermeyer in Debatin / Wassermeyer, Musterabkommen, Article 10, paragraph 39; Brähler, Controlled Foreign Companies-Rules, 2007, page 171 et seq. However, this was not the position of the government counsel in the *Schneider* Case who referred to a former decision of the Conseil d'Etat stating that the term "dividends" must be defined according to the definition given in internal law of the notion of dividends "*as earnings distributed by a company to its participants by virtue of a decision taken by the general assembly of its shareholders*" (Banque francaise de l' Orient, October 13, 1999, appeal no. 190 083, RJF 12/99, n 1587, DF 6/00, c 71, CE). This definition of the French Supreme Tax Court based on internal law therefore definitely does not comprise a deemed distribution pursuant to the French CFC rules since such an attribution is not based on the decision of the shareholders. It is questionable whether this definition covers a hidden distribution of profit. In my opinion this could be the case since a hidden distribution of profit is always caused by the shareholder relationship and therefore a "decision" of the shareholders may be assumed. This is, of course, not true for the income attribution according to Section 209 B. If the – perhaps factual – decision of the shareholder is decisive for the qualification of dividends in internal law, Article 10 (3) OECD-MTC cannot be applied to the CFC rules. Therefore, the government counsel came to the conclusion that if the dividend article is not applicable it must be other income.
[195] See Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq. (412); Vogel, Doppelbesteuerungsabkommen, Article 10, paragraph 186 et seq.
[196] However, see with respect to Article 10 (3) of the OECD-MTC: Tischbirek in Vogel / Lehner, Doppelbesteuerungsabkommen, Article 10, paragraph 223.
[197] This can also be relevant in case of persons which are related to the shareholder.

situation where the company provides some advantages to the shareholder and which negatively influences the net asset value of the company (or which prevents the company from increasing the net asset value). It is therefore rather obvious, in my opinion, to treat such a situation in a comparable manner to an "official" profit distribution and to ignore the fact that the distribution is not made pursuant to a formal procedure with an actual outflow of financial means to the shareholder. This, however, has nothing to do with the situation in case of a CFC income attribution. Here, the focus is on the *income* derived by the CFC and not on the legal entity itself. This is basically true for both approaches, the entity approach and the transactional approach, even though it is much more obvious in the latter case. Anyway, no open or hidden transfer of values from the legal entity to the shareholder exists which has a - direct or indirect - effect on the net asset value of the company.[198]

One of the main arguments for dividend income is the inseparable link between the holding of shares in the foreign legal entity and the income attribution based on the CFC rules. The existence of a shareholding in the foreign legal entity seems to be causal.[199] In fact, one of the basic requirements for the application of CFC rules is the holding of shares in the foreign company.[200] According to Vogel, it is decisive that the income which is attributed to the taxpayer under the CFC rules "stems" from the shares in the legal entity and is therefore for tax treaty purposes to be qualified as a dividend.[201] Lang and Aigner concluded that the CFC income which is allocated to the shareholder by the state of residence is caused by the shareholding in the legal entity. For this reason, Article 10 of the OECD-MTC is relevant from a tax treaty perspective.[202]

In my opinion, the reason for the dependency is easy to explain: the non-transparency of the legal entity provides for the deferral of domestic taxation of low-taxed income which would otherwise not be possible.[203] Thus, the CFC rules are applied because of the possibility of sheltering the low-taxed income from domestic taxation (and not because of the shareholding). This, by itself, is not decisive. However, there are a number of aspects which have to be taken into account and which - in my opinion - do not support the dividend approach:

- In almost all countries, the CFC income is determined according to domestic rules. The income of the foreign legal entity which may be distributed to the

[198] See in this respect also Uustalu, National Report Estonia, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, page 184.
[199] Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (721).
[200] Leaving aside constructive ownership rules.
[201] Vogel, Doppelbesteuerungsabkommen, Article 10, paragraph 224.
[202] Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq. (412, 413)); Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (721); see also Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, General Report, 2004, pages 34, 35; see with respect to Article 10 of the OECD-MTC also Haslinger, National Report Austria, pages 88-90.
[203] It has to be added that the CFC rules are not always restricted to non-transparent legal entities but sometimes also encompass permanent establishments and partnerships. Moreover, even in countries where the CFC rules solely focus on non-transparent legal entities, provisions exist which switch over from the exemption method to the credit method in case of permanent establishments and partnerships. It is therefore the exemption of low-taxed passive income which is in the focus of the high-tax countries, and this is most often - but not always - caused by the interposition of non-transparent legal entities.

shareholder is therefore typically different from (and unconnected to) the attributed CFC income. In other words, it would be rather a coincidence if the taxable income of the foreign legal entity and the taxable CFC income was identical.

- The CFC rules focus on certain types of income and - in my opinion - ignore the actual result of the foreign legal entity. This is particularly true for the transactional approach. The application of CFC rules can lead to a positive income attribution even though the result of the foreign entity is negative and the latter is therefore not in a position to distribute any profits. In such a case, the consequence of the activity which is carried out by the CFC may be a decrease in value of the shares - and at the same time the positive income is attributed and taxed in the country of the shareholder based on the domestic CFC legislation.

- Although the likelihood that the CFC rules cover the same types of income as the foreign legal entity is higher in case of an entity approach, it is by no means clear that this is the case for a period of more than one year. The change of activities can lead to the result that the foreign income is subject to CFC taxation in one year but not in the other. Thus, the basic feature of CFC rules that only certain types of income are of importance - combined with the fact that the income determination rules are different - increases the probability of a deviation between the income of the legal entity which may be distributed to the shareholder and the attributable CFC income.

- The attribution of CFC income has no influence on the income based on the commercial accounts of the foreign company and it has no influence on the net asset value (in contrast to an open or hidden distribution of profit). The company is therefore in a position to distribute all of the profits derived from its activities to the shareholder and this is - and must be - totally unconnected to a CFC income attribution.

- The actual profit distribution of the company leads to income from shares (dividend income) and reflects the added value of the investment. It is by no means comparable to the CFC income attribution. Of course, the income attribution and the actual dividend are economically - at least to a certain part - related to the same income. It is therefore necessary to avoid an economic double taxation on the level of the shareholder by the exemption of the dividend income or, alternatively, the crediting of the income taxes imposed on the CFC income attribution. Nonetheless, this is just a measure to avoid economic double taxation and does not say anything about the character of the CFC income attribution.

- It follows from the aforementioned features and the mechanism of CFC rules outlined earlier that the concept of CFC income attribution is different to the concept of dividend income. The focus on the residence state of the foreign entity and the fact that the term dividend means "*a distribution of profits to the shareholders*"[204] requires - in my opinion - a nexus between the income based

[204] See the preliminary remarks outlined in paragraph 1 of the Commentary on Article 10 of the OECD-MTC: *"(b)y "dividends" is generally meant the distribution of profits to the shareholders by companies limited by shares, limited partnerships with share capital, limited liability companies or other joint stock companies. Under*

on the commercial accounts of the company and the (open or hidden) distributions to the shareholder. It is the (net) profit of the company which is made available to the shareholder by way of profit distribution. In contrast, the CFC rules are very specific and only attribute the income in certain limited and clearly defined situations. This can have the effect that the CFC taxation is not applicable during the entire period of foreign investment but only in years where certain requirements are fulfilled. The application typically requires that (i) a certain participation threshold is exceeded, (ii) a certain low-taxation threshold is *not* exceeded, and (iii) certain income elements are derived by the foreign entity (transactional approach) or a certain mixture of income and / or certain circumstances are existent (entity approach).

Overall, I cannot follow the position that the CFC income is to be qualified as a deemed dividend (Article 10 of the OECD-MTC) - which is mainly based on the argument of a shareholding in the foreign legal entity which derives the income.

Another obstacle for the application of CFC rules under the concept of dividends might be Article 10 (5) of the OECD-MTC which states that *"(w)here a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company (...) nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."* At first glance, this seems to be a conflict with CFC taxation if it is assumed that the latter is directed to tax undistributed profits. However, it is made clear in paragraph 37 of the Commentary that *"(i)t might be argued that where the taxpayer's country of residence, pursuant to its controlled foreign companies legislation or other rules with similar effect seeks to tax profits which have not been distributed, it is acting contrary to the provisions of paragraph 5. However, it should be noted that paragraph 5 is confined to the taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder."*[205]

Moreover, even if it is assumed that the attributable CFC income is to be qualified as dividend income - in contrast to what was outlined above and in contrast to my opinion - and the income is taxed in the residence state of the shareholder, it can create a conflict under the respective double tax convention. This is the case where the "regular" dividend income is exempt from taxation whereas the (deemed) dividend income pursuant to the applicable CFC regime is taxable, and the double taxation is avoided by a tax credit system.

7.4.3. Articles 11 and 12 of the OECD Model Tax Convention

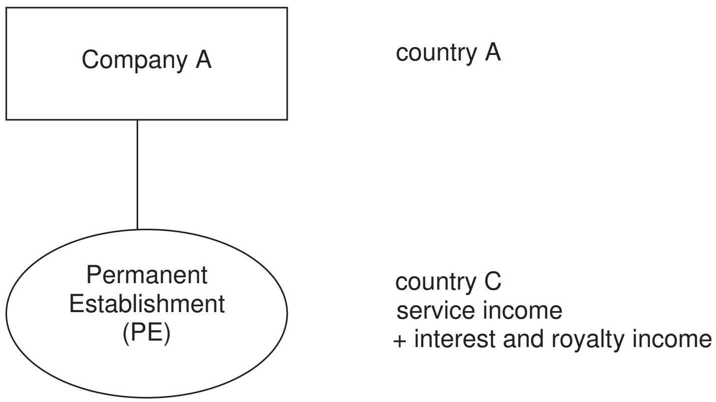
Interest income and royalty income are of particular interest: those types of income are in the focus of the CFC rules in all of the countries which apply such legislation. It

the laws of the OECD Member countries, such joint stock companies are legal entities with a separate juridical personality distinct from all their shareholders. On this point, they differ from partnerships insofar as the latter do not have juridical personality in most countries."

[205] Paragraph 37 of the Commentary on Article 10 of the OECD-MTC; see with respect to Article 10 (5) of the OECD-MTC also Portner, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International 2002, page 1679 et seq. (1692).

is therefore necessary to clarify whether Articles 11 and 12 of the OECD-MTC play a role where such types of income are included in the attributable CFC income.[206] However, I would like to start the verification again with the situation in case of a PE.

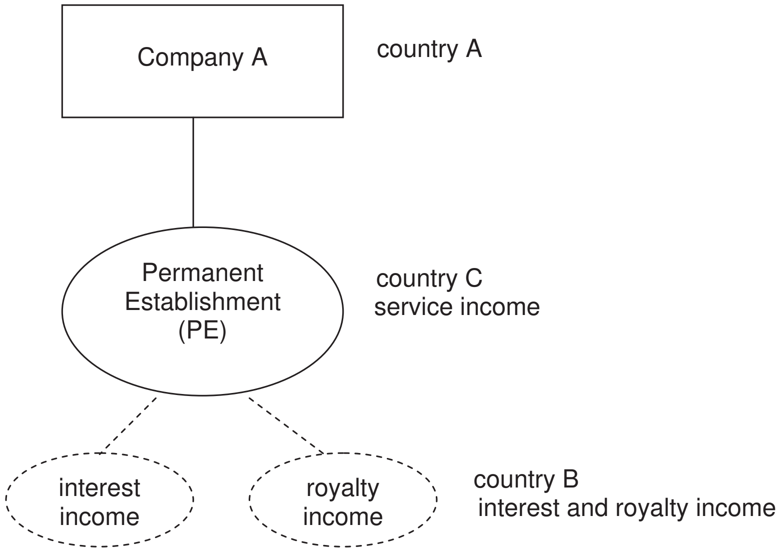
Figure 3:



In the example, the PE derives - in addition to other service income - interest and royalty income which is attributable to the PE and the source of income is in country C. Here, the outcome under the tax treaty is quite similar to the first example. The articles dealing with interest and royalty income give preference to the PE country. The same is true for dividend income. Article 11 (4) of the OECD-MTC stipulates that *"(t)he provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply."*[207] Similar rules exist for dividends and royalties.[208] In contrast to the situation outlined above, the variety of different income elements may require a separation from the perspective of country A. At least, this is true where activity clauses or domestic provisions exist which provide for a different treatment of the income elements, e.g. a partial switch-over from the exemption method to the credit method or the limitation of the offsetting of certain negative income elements. Overall, it can be concluded that interest and royalty income which is effectively connected with the PE is taxable as part of the profits of the PE.[209]

[206] See with respect to CFC income and Articles 11 and 12 of the OECD-MTC also Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 83 et seq.
[207] Article 11 (4) of the OECD-MTC.
[208] With respect to dividends and royalties see Article 10 (4) and Article 12 (3) of the OECD-MTC, respectively.
[209] As already outlined earlier in this study, it may be difficult to allocate the passive property and passive income to the PE.

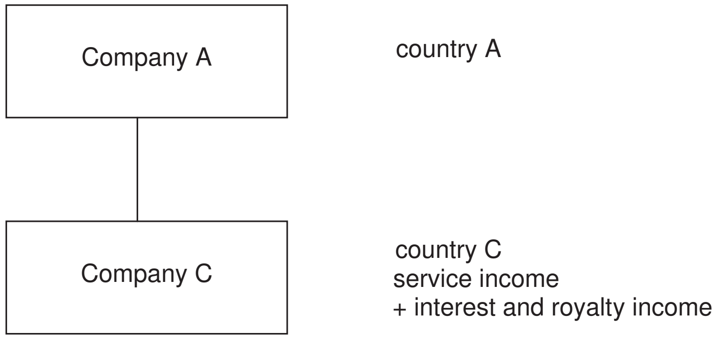
Figure 4:



Even the situation where the resident company A derives interest and royalty income in a third country (country B), and the income is effectively connected with a PE in country C, is not substantially different to the aforementioned example. Article 21 (2) of the OECD-MTC stipulates that *"(t)he provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right of property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply*." Apart from the fact that the interest and royalty payments can be subject to withholding tax in country B, the question whether a separation of the income components is required may depend, again, on the tax treaty between country A and C (e.g. activity clauses) and the domestic law of residence country A.[210] Thus, it can be concluded that interest and royalty income derived in a third country (country B) which is effectively connected with the PE is taxable as part of the profits of the PE pursuant to Article 7 of the OECD-MTC.[211]

[210] See paragraph 10 of the Commentary on Articles 23 A and 23 B of the OECD-MTC.
[211] However, this is only true under the important assumption that the interest and royalty income is allocable to the PE and not to the head office.

Figure 5:

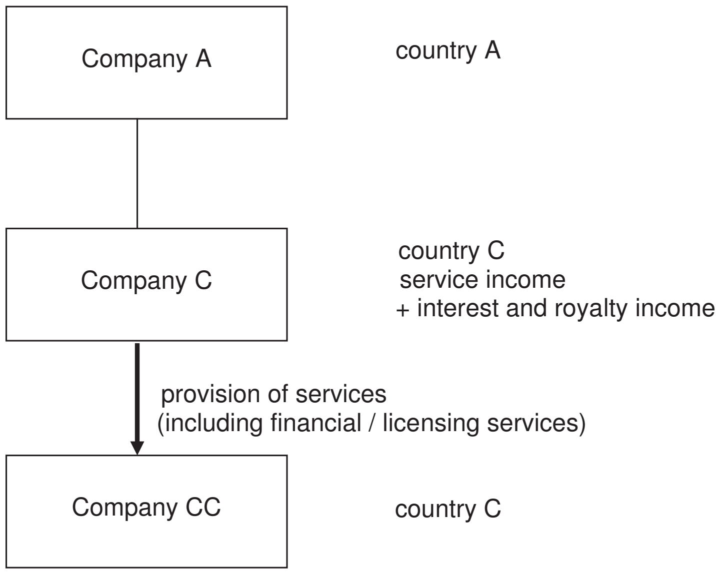


The situation is, of course, different where the “income mix” is derived by a legal entity in country C. In order to clarify the applicable treaty provisions the following differentiation can be made: interest income and royalty income derived (i) from a source of income in the residence country of the CFC (country C), (ii) from a source of income in a third country (country B), and (iii) from a source of income in the country of the shareholder (country A). Furthermore, the situation of a strict limitation to passive income without any substantial service element is to be verified separately.

a.) Interest and royalty income derived from a source of income in country C

This can be the case, for example, where – in addition to other service activities – interest income is derived from the provision of loans to companies resident in country C and the licensing out of rights to other domestic companies.

Figure 6:



Here, the situation is not substantially different from the example outlined earlier of a CFC which solely derives income from service activities. The total income is part of the business profits derived by company C and can be taxed in country C pursuant to Article 7 (1) of the OECD-MTC. At least, there is no other country involved which might have a preferred right to tax the interest and royalty income pursuant to Articles 11 and 12 of the OECD-MTC.[212] If it is assumed that the “income mix” derived in country C is subject to CFC taxation in country A,[213] the question arises whether it has to be qualified – from the perspective of country A – as business income, or whether it has to be divided into the different income elements (business income, interest income, royalty income). A third alternative would be to consider the whole amount of income as other income in the sense of Article 21 of the OECD-MTC.

In principle, the priority of the special articles provides the possibility for a limited taxation at source in the other treaty country (the source country). From the perspective of country C, this is not an issue since the income is derived from domestic sources. The whole amount of income is to be taken into account for the determination of the business profits of company C. From the perspective of the country of the shareholder, the CFC income derived in country C is not allocable to a PE and can therefore be taxed – based on the argumentation in the example of the service activities – in country A pursuant to Article 7 (1) of the OECD-MTC. The interest and royalty income form part of the allocable business profits under the CFC regime of the country of the shareholder. The tax treaty between the two countries C

[212] See Article 7 (4) of the OECD-MTC.
[213] At least in the example it shall be assumed that the income is subject to CFC taxation. However, this is not necessarily the case - depending on the respective CFC rules - if the income is derived from activities carried out in the residence state of the CFC.

and A does not prevent the latter country from taxing the income. In my opinion, the fact that additional income elements are included in the attributable CFC income does not lead to a different outcome. The latter is, in my opinion, supported by the outcome of the European case law outlined under section 7.2.[214] The net income derived from the activities carried out in country C is still to be considered business income, and this also includes services related to financing and licensing. As already outlined above, the activity, and therefore also the net income derived from this activity, has to be qualified, in my opinion, as a whole. If it turns out that the activity is to be considered a business activity, there is no necessity for a further separation of the net income and the different elements which make up the business income. Here, it does not play any role, in my opinion, whether the country which applies the CFC rules follows an entity approach or transactional approach. In contrast thereto, Sandler takes the position that the attributed income retains its character. According to Sandler, this would mean that under an entity approach CFC taxation the entire attributed income should be qualified as “profits” of the CFC. In case of a transactional approach CFC taxation the attributed income should be subdivided into the different types of income, i.e. business profits, dividends, interest, royalties or capital gains.[215] This might be supported by paragraph 38 of the OECD-Commentary on Article 10 where such an approach is basically seen as a possibility. However, I do not see that the domestic approach of creating a link to the income of the CFC and the question how much of the income should be attributed, i.e. by way of following an entity approach or a transactional approach CFC legislation, should result, as outlined above, in a different conclusion with respect to the attributable net income.

However, one could argue that the definitions included in Articles 11 (3) and 12 (2) of the OECD-MTC also affect the income qualification under the tax treaty for purposes of income allocation according to the CFC regime of country A. I do not think that this is the case. The abstract definition of interest and royalties is of significance for the identification and separation of the gross income for the purpose of allocating taxing rights to the source country in order to provide for a limited taxation at source (withholding taxation) but not for the allocation of the net income pursuant to the CFC regime.[216] It is therefore - from a domestic perspective - important to know the underlying type of income in order to determine the amount of CFC income, but it is

[214] The Belgian subsidiary in the *A Oyj Abp* Case, *inter alia*, provided financial services. The same was true in the *Bricom Holdings* Case where the Dutch subsidiary of *Bricom* derived interest income from loan amounts granted to the UK companies. In both cases, the fact that interest income was included in the attributed CFC income did not play any role for the qualification of the income attributed to the shareholders. In the *A Oyj Abp* Case, the income was qualified as business income. In the *Bricom Holdings* Case, the attributed income under the UK CFC regime was considered “a purely notional sum” which finally did not represent any interest income. Also in the *Schneider* Case, where the activity of the Swiss subsidiary of *Schneider* encompassed, *inter alia*, the holding and management of bonds and securities, the type of income received by the Swiss subsidiary finally did not play any role for the qualification of the CFC income. In the Swedish *Captive Insurance* Cases the Council for Advance Tax Rulings concluded that the profit derived by the captive insurance companies in Luxembourg and Switzerland was not the same as the income which is attributable to the Swedish parent company under the Swedish CFC regime. Essentially, the Council for Advance Tax Rulings qualified the CFC income as business income - alternatively other income - but did not refer to the income components derived by the captive insurance companies, either.

[215] Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 95.

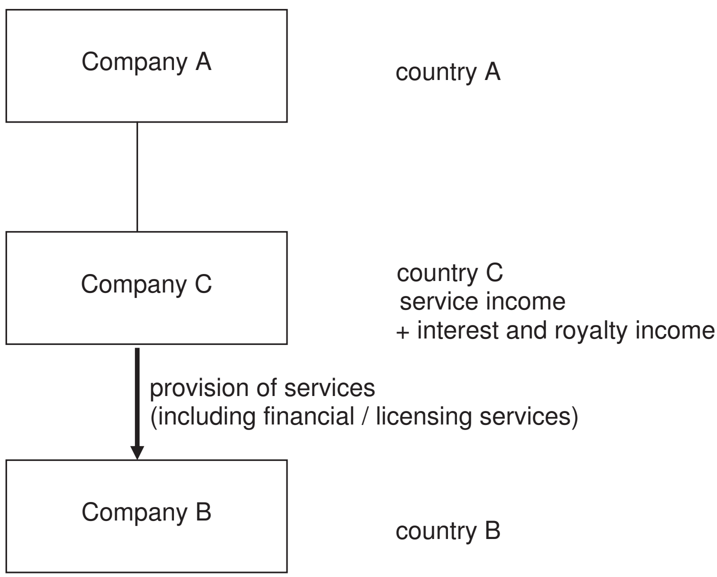
[216] There seems to be no basis to derive such a limitation from Articles 11 and 12 of the OECD-MTC. To this extent, I fully agree with the outcome of the *Bricom Holdings* Case. The interest or royalty income received by the subsidiary company is not included (as the same type of interest and royalty income) in the income attributed according to the CFC regime.

the total net income (entity approach) or a certain part of the net income (transactional approach) which is attributed to the shareholder. The income as such is derived from a business activity and is therefore - in my opinion - to be qualified as business income, even if it is the result of a "mixture" of different income components. In any case, the proposed solution does not leave any room - from my perspective - for the application of Article 21 of the OECD-MTC.[217]

b.) Interest and royalty income derived from a source of income in a third country

In the following alternative, it is assumed that company C derives interest and royalty income from the provision of financial services and the licensing out of intangible assets to another group company (company B) resident in country B.

Figure 7:



The interest and royalty income is part of the business income derived by company C. However, Article 7 (4) of the OECD-MTC gives preference to Articles 11 and 12 of the OECD-MTC which may lead to a source based taxation – at least with respect to the interest income – in country B. In effect, a withholding tax may be deducted from the gross amount of interest paid from company B to company C which would not be the case if Article 7 (1) of the OECD-MTC were applicable only for the allocation of

[217] However, the application of Article 21 of the OECD-MTC would not lead to a different outcome, either. If the income is considered to be other income form the perspective of country A, the taxing rights will be allocable to country A. Article 21 (1) outlines that *"(i)tems of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State."* As already outlined above, the Council for Advance Tax Rulings in the Swedish *Captive Insurance* Cases qualified the CFC income as business income for tax treaty purposes, but also referred to other income (as an alternative qualification for tax treaty purposes).

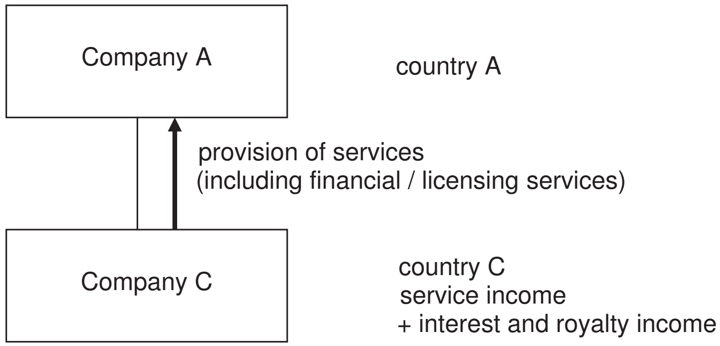
taxing rights (due to the fact that there is no permanent establishment involved). The preference of the special articles over Article 7 of the OECD-MTC is important in the first step. However, in the second step the net amount of income is calculated on the level of company C. Here, all income elements derived from the activities carried out by company form part of the business profits and are taxable in country C pursuant to Article 7 (1) of the OECD-MTC.[218] The special articles do not have any effect on the net income determination and the scope of the business profits derived by company C. That means, the effect of the special articles is restricted to the admission of a limited taxation of the gross amount of interest (or royalty) payments in the source country but by no means restricts or influences the net income determination of the business income in country C.[219]

In contrast thereto, the tax treaty between country A and country B is of no relevance for the outcome since company C is typically recognised as a non-transparent legal entity and a resident company of country C. It is therefore – also from the perspective of country A – the tax treaty between country B and country C which is decisive for the allocation of taxing rights related to the interest and royalty income. What remains is the relationship between countries A and C. Here, the result is exactly the same as in the examples mentioned above: the CFC income is to be qualified as business income which can be taxed in the hands of the resident company A pursuant to Article 7 (1) of the OECD-MTC. The fact that part of the attributable CFC income is due to interest and royalty payments does not play any role for the qualification of the net income as business income.

c.) Interest and royalty income derived from a source of income in country A

The provision of services of a subsidiary company situated in a low-tax country towards the parent company is, of course, one of the typical situations within a multinational group of companies.

Figure 8:



[218] As already described earlier, this conclusion is supported by the outcome of the European case law outlined under section 7.2.
[219] An additional effect is, of course, the necessity to provide for a tax credit of the withholding taxes (see Article 23 A (2) of the OECD-MTC).

Article 11 (1) of the OECD-MTC stipulates that *"(i)nterest arising in a Contracting State paid to a resident of the other Contracting State may be taxed in that other State."* Thus, the OECD-MTC allocates the taxing rights for the interest income to country C. However, in Article 11 (2) of the OECD-MTC a limited right to tax is granted to the source country (country A) which *"(…) shall not exceed 10 per cent of the gross amount of the interest."* In contrast thereto, Article 12 (1) of the OECD-MTC does not provide for a limited taxation at source but allocates the taxing rights solely to country C: *"(r)oyalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State."* Therefore, the taxing rights related to the interest and royalty payments are clearly stipulated and – apart form the limited possibility of a withholding taxation of interest payments – allocated to country C. Based on the clear limitations one could take the position that there is no room for a CFC taxation of the interest and royalty income, either.[220] In fact, this was one of the questions raised in the *Bricom Holdings* Case outlined earlier where the Court of Appeal in the United Kingdom concluded that "*the interest received by Spinneys (here: company C) is not included in the sum apportioned to the taxpayer (here: company A) on which tax is chargeable. It merely provides a measure by which an element in a conventional or notional sum is calculated, and it is that conventional or notional sum which is apportioned to the taxpayer and on which tax is charged*."[221] Even though the peculiarities of the United Kingdom CFC rules have to be taken into account, the statement is partly true, at least insofar as it makes clear that the interest income is of no relevance in the second step of a two-step approach: first, the actual interest payment (or royalty payment) has to be seen in the light of the special articles. Here, the possibility of a withholding taxation may be granted to the source country. Second, the interest payments (or royalty payments) "amalgamate" with all the other income derived by company C and the "income mix" is determined on a net basis, i.e. the related expenses are taken into account. In fact, the net income in the second step is determined twice: (i) for the purpose of taxation of company C in country C and (ii) for the purpose of CFC income taxation of the resident parent company A in country A. However, the statement might give the impression that the "*notional sum*" is not to be qualified for the purpose of the underlying treaty. This, of course, should not be true.

If the taxation of the PE according to the credit method is compared to the taxation of the shareholder according to the CFC rules, it is quite obvious that - apart from the substantial difference related to the separate taxable person in country C and the fact that the CFC taxation leads to an economic instead of a juridical double taxation of income - the overall tax burden can be identical.[222] Furthermore, and this is more interesting in this context, the qualification of income is the same. In case the service income, interest income and royalty income is derived by the PE - and is effectively connected with the PE - it will lead to a qualification as business income pursuant to Article 7 of the OECD-MTC. In this case, no separation will be made into the different types of income elements for tax treaty purposes. The same should be true - in my

[220] See in this respect Portner, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International 2002, page 1679 et seq. (1691); Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, pages 105-107.
[221] (1997) STC 1179, on page 1195.
[222] The Finnish Supreme Tax Court also referred to this point in the *A Oyj Abp* Case: "*From the standpoint of Finnish domestic taxation, double taxation does not arise because the tax on the controlled foreign company does not exceed the amount which would have been collected if the controlled foreign company had not been established and its activities had been carried out in Finland or through a branch situated abroad* " (ITLR, Volume 4, 2002, page 1073).

opinion - for the income qualified as CFC income according to the residence state of the shareholder. The income derived by the foreign legal entity (instead of the PE) is to be qualified as business income - irrespective of the fact that income elements are included which are related to interest and royalty payments. This is true for both, the residence state of company C and the residence state of company A which applies its CFC rules.

d.) The strict limitation to passive income without any substantial service element

The question arises whether the outcome of the examples would be different in cases where the activity does not comprise any substantial service elements but is solely limited – for example – to the deriving of interest income. Supposing, the only activity carried out by company C is to invest the capital received from the parent company in interest bearing bonds. The activity shall not be carried out as a professional asset management activity but is just limited to the investment in very few financial assets and without substantial trading activities.[223] It shall further be assumed that the activity as such – even though the functions are quite limited – will be accepted by the state of the shareholder as an activity actually carried out by company C.[224] In such a case, the income derived by company C only encompasses interest income from the investment in a limited number of bonds. Since it is assumed that the tax treaty between countries A and C follows the OECD-MTC, Article 11 (3) stipulates that *"(t)he term "interest" as used in this Article means income from debt-claims of every kind, (…) and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures."* Thus, the income derived by company C – in general – matches with the definition included in Article 11 (3). There is no necessity to refer to domestic law in order to clarify the definition of interest. In Article 11 (1) it is determined that *"(i)nterest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State."* However, the interest arises in country C (alternatively: in country A or B) but is not transferred to the resident company A. Instead, the interest remains in country C (alternatively: is transferred from country A or B to country C). Thus, the right to tax the interest income derived by company C is allocable to country C and becomes part of the net income of the latter company which is taxed as business profits pursuant to Article 7 (1) of the OECD-MTC.[225]

In addition, the type of CFC income must be determined from the perspective of country A in the light of the respective tax treaty. Here, it might be argued that the complete attributable CFC income is based on an activity which leads to interest income, i.e. the net income attributable to the resident shareholder is solely the result of capital investment. However, I do not think that the definition of "interest" included in Article 11 (3) of the OECD-MTC is of importance in this respect. The latter is to be seen in the context of Article 11 of the OECD-MTC, i.e. for the allocation of taxing rights related to the gross amount of interest income between the source country and the country which receives the actual interest payment (country C). The residence country of the shareholder does not receive any actual interest payment. The allocation rules of Article 11 (1) and (2) are - in my opinion - of no relevance to the

[223] "Trading" in the sense of the purchase and selling of bonds.
[224] That means it shall be assumed that no abuse of law exists.
[225] What remains is a limited taxation at source if the interest income is derived from sources in country A or B (Article 11 (2) of the OECD-MTC).

attributable CFC income in the relationship between countries A and C. At least, it should be clear that Article 11 does not restrict the taxing rights related to the attributable CFC income.

Thus, the CFC income has to be qualified with reference to the domestic legislation of the country which applies the tax treaty. In the example, it is not unlikely that the domestic legislation treats the activity as an asset management activity which does not fulfil the domestic requirements of a business activity. In such a case it can be necessary to separate the income into the different types. In the underlying example of the limited investment in bonds, the income may be determined as interest income. The income which is allocable to the resident shareholder pursuant to the domestic CFC rules will therefore be included in the domestic tax base as part of the business profits of company A (even though it is to be qualified as interest income for tax treaty purposes) and taxed pursuant to Article 7 (1) of the OECD-MTC. Thus, the taxation of the CFC income would not be restricted by the relevant tax treaty.

It should be clear that the result is not limited to interest income. Theoretically, other asset management activities are thinkable which do not fulfil the requirements of business income. This may be especially true for dividend income, i.e. portfolio income derived by the CFC,[226] and royalty income. However, the situations where the latter type of income is *not* to be qualified as business income are certainly limited. In any case, Articles 10 (1) and 12 (1) of the OECD-MTC may generally not restrict - in the same way as Article 11 (1) of the OECD-MTC - the taxation of CFC income in the residence state of the shareholder.[227] It has to be clarified in this context that the wording "*shall be taxable only*" in Article 12 (1) of the OECD-MTC may not prevent country A from taxing the CFC income which is qualified as royalty income. Company C (which is the actual recipient of the royalty payments) and company A are two different entities which are resident in two different countries. Article 12 (1) of the OECD-MTC is therefore not capable of creating a limitation for the CFC taxation of country A.[228]

e.) Excursion: income from portfolio dividends

The conclusions drawn under letter a.) to d.) are equally relevant for portfolio dividends included in the respective income, i.e. in addition to (or instead of) interest and royalty income. As already outlined earlier, the portfolio dividends are not to the

[226] To the extent that the dividends are actually in the focus of CFC rules.

[227] The problem related to participation exemption and dividend income is addressed separately.

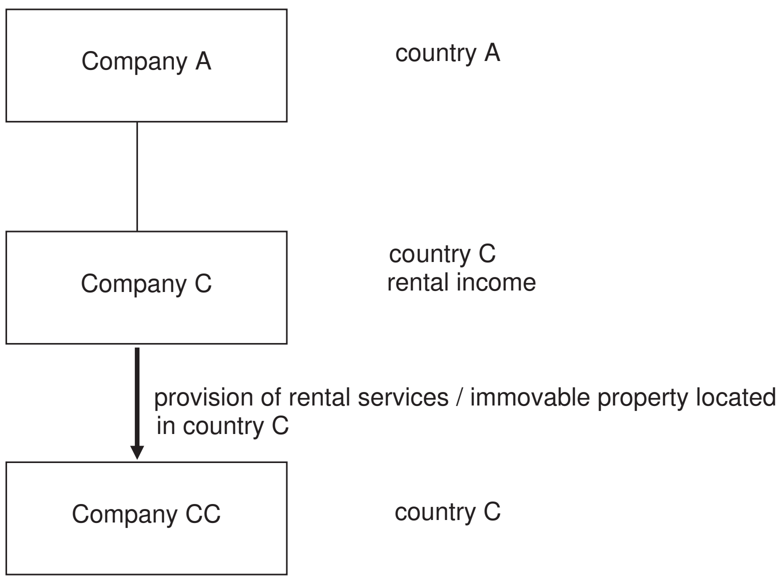
[228] However, the commentators which follow the "Zurechnungstheorie" ("transparency approach" or "look-through approach") take the position that the attributed income is to be divided into the respective components (interest income, royalty income et cetera). See in this respect Köhler, Die steuergesetzliche Tatbestandsbildung der Zugriffsbesteuerung nach dem Außensteuergesetz, Recht der Internationalen Wirtschaft 1988, page 979 et seq.; see in this respect also Rix who outlined that *"(i)t is questionable if the total CFC income, which is allocated to a Danish resident shareholder, can be classified as dividends (confer Art. 10 (3)), as the allocated CFC income should be taxed and classified in accordance with its character, i.e. interest, royalty etc."* (Rix, National Report Denmark, in Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, 2004, pages 156, 157). In my opinion, the explanations in the OECD-Commentary are rather confusing: *"(i)f the income were attributed to the taxpayer then each item of the income would have to be treated under the relevant provisions of the Convention (business profits, interest, royalties). If the amount is treated as a deemed dividend then it is clearly derived from the base company thus constituting income from that company's country. Even then, it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 or as "other income" within the meaning of Article 21"* (see paragraph 38 of the Commentary on Article 10 of the OECD-MTC).

same extent subject to CFC taxation as interest income and royalty income. However, in those countries where the portfolio dividends are included in the attributable CFC income the explanations above may in general be referred to.

7.4.4. Article 6 of the OECD Model Tax Convention

Article 6 of the OECD-MTC deals with income from immovable property. In contrast to Articles 11 and 12, the state of source has the right to tax the income from immovable property which, of course, reduces the possibility to shift income from a high-tax country to a low-tax country.[229] The income from immovable property, such as rental income, is therefore not the main target of CFC regimes. However, the income from immovable property should not be excluded from the verifications in those situations where it can theoretically be subject to CFC taxation.[230]

Figure 9:



Article 6 (1) of the OECD-MTC outlines that *"(i)ncome derived by a resident of a Contracting State from immovable property (...) situated in the other Contracting State may be taxed in that other State."* Articles 6 (2) and (3) of the OECD-MTC make it clear that *"(t)he term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is*

[229] At least in those cases where the immovable property is located in a high-tax country but owned by a group-company situated in a low-tax country. Article 6 (1) of the OECD-MTC stipulates that *"(i)ncome derived by a resident of a Contracting State from immovable property (…) situated in the other Contracting State may be taxed in that other State."*
[230] See with respect to CFC income and Article 6 of the OECD-MTC also Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, pages 132, 133.

situated (...)"[231] and *"(t)he provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.*"[232] Furthermore, Article 6 (4) of the OECD-MTC stipulates that the relevant provisions also apply to income from immovable property of an enterprise. Paragraph 4 of the Commentary on Article 6 of the OECD-MTC states that *"(...) the right to tax of the State of source has priority over the right to tax of the other State and applies also where, in the case of an enterprise, income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the Article do not prejudge the application of domestic law as regards the manner."*

In the example, and from the perspective of country C, the income from immovable property will be taxed in country C. In fact, this is not a relevant issue under a double tax convention since the income is derived from domestic property. Theoretically, the low-taxation of the rental income might trigger the CFC taxation of country A. However, there is a major difference between interest income, royalty income, dividend income (which may be included in the allocable business income) and rental income: the concept of Article 6 of the OECD-MTC requires a source based taxation of the rental income and is by no means limited to a withholding taxation of the gross amount of income. The taxation of rental income is therefore based on a net concept. In principle, if one follows the reasoning outlined above with respect to the other types of income, this will not lead to another outcome with respect to the CFC taxation of rental income. The classification of rental income from the perspective of state A - for example if the activity of company C cannot be considered a business activity, but solely a non-professional asset management activity which is related to income from immovable property - would not lead to the result that the income cannot be taxed in the hands of company A. In general, there are two different persons involved: company C (as the direct owner of the immovable property) and company A (as the shareholder in company C). The classification of income is therefore to be made separately for two different persons by two different states. Hence, Article 6 of the OECD-MTC does not directly restrict the taxing rights of state A related to company A in this respect. It is not the intention of state A to tax company C in state A on income derived from rental activities. For this reason, a limitation of taxing rights which follows the concept of Article 6 of the OECD-MTC could only be made by analogy. However, it is questionable whether such an analogous application of Article 6 of the OECD-MTC - which might result in a restriction of the application of CFC rules for this particular type of income - can be justified. In my opinion, the only theoretical justification for an analogous application of Article 6 of the OECD-MTC might be derived from the concept of a strict source-based taxation of the net income from immovable property. However, this would require that (i) both contracting states follow such an approach not only in relation to each other but also in relation to third states (because otherwise there might be a shifting of rental income from third states to the state of the CFC) and (ii) the concept clearly limits the income taxation to the state of source and does not allow the elimination of double taxation by the application of the credit method. In such a situation, it is not only questionable

[231] Article 6 (2) of the OECD-MTC.
[232] Article 6 (3) of the OECD-MTC.

whether a CFC taxation of such income in state A is actually required from an anti-avoidance perspective, but one might also argue that the application of those rules to income from immovable property is in contradiction to the purpose and the idea of the respective tax treaty. One could even raise the question whether the attribution of rental income in the aforementioned situation results in the circumvention of the respective tax treaty. The question of the application of CFC rules and the circumvention of tax treaties will be discussed below in more detail. However, I do not think that this problem can be solved by the analogous application of Article 6 of the OECD-MTC - because I do not see any legal basis for such an analogous application - but rather by the structuring of the domestic CFC rules. This, of course, will be discussed in detail in chapter 9.

7.4.5. Article 13 of the OECD Model Tax Convention

Pursuant to Article 13 of the OECD-MTC, the taxing rights related to the gains realised from the alienation of property - especially the property which is of relevance in the context of CFC taxation - shall be taxable only in the state of which the alienator is a resident. This is different, amongst other, for gains realised from the alienation of immovable property and for gains realised from the alienation of movable property which forms part of the business property of a permanent establishment in the other state.[233] The principles outlined above are equally relevant for capital gains: if the activity is to be qualified as business activity, the capital gains are part of the allocable business income. In all other cases, the qualification is to be made with reference to the domestic legislation of the country which invokes the respective double tax convention. The wording "*shall be taxable only*" in Article 13 (5) of the OECD-MTC is no obstacle for the taxation of CFC income. There are two different resident companies involved. The restriction of the taxation in country C is of no relevance for the taxation of the resident company A in country A.[234]

7.4.6. Article 21 of the OECD Model Tax Convention

Article 21 of the OECD-MTC (other income) can only be applicable to items of income which are not dealt with in the foregoing Articles, i.e. especially Articles 6, 7, 10, 11, 12 and 13 of the OECD-MTC. As I have already outlined above the CFC income attribution to the resident shareholder is - depending on the situation - very often to be qualified as business income under the relevant double tax convention. In other cases, interest income, royalty income and dividend income might play a role. Thus, there is consequently not much room for the application of Article 21 of the OECD-MTC. However, if one takes the position that the CFC income cannot be qualified as business income, dividend income, interest income, royalty income, or even rental income, due to the fact that the CFC rules solely refer to the income derived by the foreign legal entity but the shareholder does not derive the same type of income directly, the outcome might be different. If the amount of CFC income is just seen as a "*notional amount*" which is "*merely a product of a mathematical*

[233] Capital gains related to immovable property are most often not included in the income of the foreign entity (see Article 13 (1) of the OECD-MTC). However, the tangible and intangible property which is of relevance in the context of CFC taxation is typically subject to tax in the low-tax country (see Article 13 (5) of the OECD-MTC).
[234] See with respect to CFC income and Article 13 of the OECD-MTC also Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, pages 137-139.

calculation"[235] one could come to the conclusion that the shareholder in the foreign legal entity derives other income instead of business income (or other types of income). The Commentary to the OECD-MTC is unclear in this respect. Paragraph 38 of the Commentary on Article 10 outlines that *"(i)f the amount is treated as a deemed dividend then it is clearly derived from the base company thus constituting income from that company's country. Even then, it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 or as "other income" within the meaning of Article 21."* However, even if one follows a position according to which the CFC income is to be qualified as other income (which is not my position) this would not lead to a different outcome: the taxing rights related to other income are allocable to the residence state of the shareholder which applies its CFC taxation.[236]

7.4.7. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The type of income in the context of the basic interest taxation has to be determined - just like in case of the application of the typical CFC regimes - in the light of the respective double tax convention. If the income qualification leads to the outcome that the residence state of the shareholder has the right to tax the basic interest income, there is, in principle, no restriction for the application of such a concept. The question is, however, whether the method for the qualification of the basic interest income is different from the method for the qualification of income attributed under the typical CFC regimes. In essence, what makes the basic interest taxation different from CFC taxation is the (additional) vertical separation of income instead of the mere horizontal separation of income (under the transactional approach) or the non-separation of income (under the entity approach if the income is not completely exempt from CFC taxation). In both cases, the basic interest taxation and the CFC taxation, the decisive element is the current taxation of income which is "connected" to an activity of another entity. The method of separating such income for the purpose of current taxation (vertical and / or horizontal) is quite important from an economic and equity perspective, as I have stated in chapter 2 and chapter 3, but it should not make any difference when it comes to the qualification of income. The basic interest income - which is, in essence, the result of a horizontal and vertical separation of income - should still be linked to the activity of the CFC in order to determine the type of income for tax treaty purposes. That means it is the activity carried on by the CFC which has to be assessed and which should be the basis for the income qualification of the residence state of the shareholder (the state which applies the system of current taxation of income). Overall, the method of income qualification should be identical for the current taxation according to the typical CFC regimes and the current taxation according to the concept of basic interest taxation. However, I will come back to the different approaches in the following section.

[235] See in this respect the *Bricom Holdings* Case outlined earlier. See with respect to CFC legislation and Article 21 of the OECD-MTC: Lang / Aigner / Scheuerle / Stefaner, CFC Legislation, Tax Treaties and EC Law, General Report, 2004, pages 36, 37 (including the references to the National Reports (footnote 129 of the General Report); Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 83 et seq.; Brähler, Controlled Foreign Companies-Rules, 2007, page 177 et seq.
[236] See Article 21 (1) of the OECD-MTC.

7.5. The Different Approaches of CFC Income Taxation and Double Tax Conventions

7.5.1. Entity Approach vs. Transactional Approach

The question arises whether the outcome could be different depending upon whether the country which applies a CFC taxation follows an entity approach or a transactional approach.[237] The countries which follow the latter approach focus much more on the separate types of income derived by the CFC. However, both approaches follow a system which creates a link to the activities of the foreign legal entity and the income derived by this entity. The transactional approach only attributes net income which is derived from certain base company and passive activities. Other activities are excluded from current taxation. In contrast, the entity approach verifies the extent of certain activities and - depending on the result of this verification - attributes all of the income or none of the income to the shareholder ("all-or-nothing" approach). However, in both cases the income attributed according to the transactional approach and the entity approach is often not equal to the result of the foreign legal entity. I do not think that the domestic methodology of creating a nexus to the income of the CFC can be of any influence for the qualification of income under the respective tax treaty.[238] If it is only a certain portion of the net income which is attributed to the shareholder - instead of the complete net income derived by the foreign legal entity - this should not change the qualification of the activity. If the net income is to be qualified as business profits but the current taxation under the CFC regime is restricted to a specific part of the business profits which is originally derived from - for example - interest and royalty income, this should not lead to the result that the portion of the attributable net income is now to be qualified as interest and royalty income instead of business income.[239] Otherwise, it would be the domestic structure of CFC legislation which is decisive for the qualification of the attributed CFC income by the mere fact that it refers to certain income components and through a restriction of the income attribution to the net result which is indirectly related to such income elements. In contrast, a CFC regime which follows an entity approach would not have such a decisive influence. In other words, the activity and the net income of the CFC are to be qualified independent of the limitations provided by domestic law and irrespective of whether the CFC regime follows a transactional or an entity approach.

---

[237] For the details regarding the transactional approach and the entity approach see chapter 6. See with respect to the question of tax treaties and transactional / entity approach also Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 95 et seq.

[238] See in this respect also Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq.; Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Aigner, Die Abkommensberechtigung bei Anwendung einer CFC-Gesetzgebung, Internationale Wirtschafts-Briefe 2002, page 1637 et seq.; Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 83 et seq.; however, see also the perspective of Sandler in Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, Second Edition, 1998, page 95 et seq.

[239] See the previous examinations; Brähler, Controlled Foreign Companies-Rules, 2007, page 126 et seq.

7.5.2. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The conclusions with respect to the different CFC approaches (transactional approach, entity approach) can be transferred, as already stated above, to an approach which is based on the current taxation of the basic interest component. Not the structure of the national legislation - just by referring to specific parts of the income of the CFC - should be decisive for the qualification of income for tax treaty purposes, but the activity of the CFC has to be assessed from the perspective of the state which applies the system of current taxation of income. This, again, is an important conclusion since it provides the basis for an alternative system which strictly focuses on the combination of a horizontal and a vertical separation of income and which should be in line with the OECD-MTC. The horizontal separation of income ensures that activities which do not include a separable financing element are excluded from the current taxation of income. The vertical separation of "tainted" income ensures, in addition, that the income element which is produced by the CFC and the income element which is related to the risk coverage - which are theoretically both part of the "tainted" income - are excluded from the current taxation of income. The combination of a horizontal and a vertical separation of income results in the safeguarding of competitiveness and limits the current taxation of income to the most critical element from an anti-avoidance (anti-deferral) perspective. In other words, there is no restriction with respect to the OECD-MTC, neither based on the case law described earlier[240] nor based on the OECD position, which does not allow to follow a concept which is - as much as possible - based on the principle of capital import neutrality combined with a current taxation of income which is limited to the basic interest component.

7.6. The Circumvention of Double Tax Conventions through CFC Legislation?

7.6.1. General Aspects

Obviously, if one follows the position that there is no necessity to preserve the CFC rules in the respective double tax conventions and the countries which apply such regimes have the possibility of taxing the CFC income pursuant to Article 7 (1) of the OECD-MTC, one could argue that there is a certain risk that the application of CFC rules might lead to a circumvention of double tax conventions.[241] For example, the residence country of the shareholder could stipulate in its domestic legislation a link which not only encompasses certain base company activities and passive activities but also business activities carried on by the foreign legal entity with third party

[240] With the exception of the *Schneider* Decision (as outlined earlier).
[241] See with respect to CFC legislation and the circumvention of tax treaties Rao, Wassermeyer and Lang in IFA, Abusive Application of International Tax Agreements, 2001, page 21 et seq.; Arnold / Dibout in IFA, Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends, General Report, 2001, pages 81-84; Schön, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht, Der Betrieb 2001, page 940 et seq.; Schön, CFC Legislation and European Community Law, British Tax Review 2001, page 250 et seq.; Lang, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht 2002, page 717 et seq. (722, 723); Lang, CFC Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, page 51 et seq.; Aigner, Die Abkommensberechtigung bei Anwendung einer CFC-Gesetzgebung, Internationale Wirtschafts-Briefe 2002, page 1637 et seq.; Aigner, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International 2002, page 407 et seq.; Aigner, Hinzurechnungsbesteuerung und DBA-Recht, 2004, page 83 et seq.; Debatin, Deutsche Steuer-Zeitung 1971, page 98 et seq.; Vogel, Betriebs-Berater 1971, page 1189; Kluge, Recht der Internationalen Wirtschaft 1975, page 531; Leisner, Recht der Internationalen Wirtschaft 1993, page 1016.

customers. This could have the effect that all (or nearly all) activities of the foreign legal entity are subject to CFC taxation in the residence country of the shareholder. This would go much further than the existing transactional and entity approaches. Even in the latter case of an entity approach there is only an income attribution in those tax years where certain activities prevail. Such a broad concept of CFC taxation would reflect the principle of capital export neutrality applied to all types of income. The 1992 version of the Commentary states that *"(t)he majority of Member countries accept counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, but believe that such measures should be used only for this purpose. It would be contrary to the general principles underlying the Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected. Counteracting measures should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer."*[242] This seems to be a clear position of the majority of the OECD Member countries against the general application of CFC rules to all types of income and for a strict limitation to base company activities and passive activities. The wording in the 2003 update of the Commentary is different and does not explicitly refer to such a strict limitation. Paragraph 26 outlines that *"(s)tates that adopt controlled foreign companies provisions or the anti-abuse rules referred to above in their domestic tax laws seek to maintain the equity and neutrality of these laws in an international environment characterised by very different tax burdens, but such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer."*[243] However, even without the clear reference to the active-passive differentiation the CFC rules are still considered to be anti-abuse measures.[244] Those measures should therefore – from the perspective of the OECD – still be limited to the aforementioned base company activities and passive activities. It would certainly be problematic to stipulate a participation exemption in a tax treaty which exempts dividend income and capital gains derived from certain shareholdings but to tax all of the income derived by the foreign legal entity through the application of CFC rules. Such an approach would not only be inconsistent, it might lead to a circumvention of the tax treaty where it has the effect of a complete and unrestricted taxation of the whole CFC income. On the other hand, if a country follows the approach of taxing the world-wide income of its residents (based on the principle of capital export neutrality) by a strict application of the credit method (PE income, dividend income, capital gains), one can certainly not argue that the application of CFC rules are contrary to the general principles underlying the tax treaties and to the spirit of the tax treaties. It was outlined earlier that those rules are accepted by the OECD as domestic measures which can be applied without any explicit preservation in a tax treaty. The business profits derived by the foreign legal entity would still be taxable in the source country and as long as the country which applies the CFC rules provides for a crediting of the foreign income tax an economic double taxation would be avoided. The main

242 Paragraph 26 of the Commentary on Article 1 of the OECD-MTC (1992).
243 Paragraph 26 of the Commentary on Article 1 of the OECD-MTC (2003).
244 Paragraphs 22, 23 of the Commentary on Article 1 of the OECD-MTC.

consequence in case of a credit country is the immediate taxation of income in the residence state of the shareholder and the avoidance of tax deferral. However, the general application to the complete profit from active businesses derived by the foreign entity would clearly be, in my opinion, an obstacle from an economic point of view.[245] Overall, it must be concluded that the position of the OECD is contradictory regarding the application of CFC rules: on the one hand, the CFC rules shall not be addressed in tax treaties and shall therefore not be affected by them, i.e. there is, in principle, no restriction on the application of domestic CFC rules through tax treaties. On the other hand, the CFC rules shall only focus on certain activities and shall only be applied if the taxation is not comparable to that of the state of residence of the shareholder. The limitations, of course, should not be acceptable for a state which strictly follows the principle of capital export neutrality, because the latter approach requires the immediate taxation of all types of income and irrespective of whether the tax rate is comparable or not. Any deferral of domestic income taxation is not in line with such an approach. For this reason, the strict and consistent application of the principle of capital export neutrality can hardly be considered a circumvention of the underlying tax treaty if the legislation which leads to the current taxation of income is not affected by the respective tax treaty.

7.6.2. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The circumvention of double tax conventions might be an issue, as already outlined above, if the domestic legislation establishes a link to the income derived through another entity which carries on its activity in the other contracting state. However, there is a difference between the typical CFC regimes and the concept which is based on the taxation of the basic interest component. In case of CFC regimes it is possible that an amount is attributed and taxed in the residence state of the shareholder which is identical or almost identical to the income realised through the CFC. This is possible under a transactional approach (e.g. where the activity of the CFC solely focuses on tainted activities) and under an entity approach (e.g. where base company activities prevail). However, the typical CFC regimes do not focus on a complete and unrestricted taxation of the CFC income, but focus on income from certain (passive and base company) activities. The concept which is based on the taxation of the basic interest component goes even further and already excludes, in general, the income which is produced by the CFC and the income which is related to the compensation of risks by the CFC. Moreover, only activities which contain a financing element are subject to current taxation. Thus, the combination of excluding certain income (horizontal separation of income) together with the separation of the remaining “tainted” income into the respective elements (vertical separation of income) makes it less likely (compared to the typical CFC rules) that an amount is attributed and taxed in the residence state of the shareholder which is identical to the total amount of income realised through the CFC. For this reason, the application of a system which focuses on the taxation of the basic interest component clearly does not result, in my opinion, in a circumvention of double tax conventions. Moreover, the basic interest taxation might lead to greater acceptance of the current taxation of income within the OECD countries (and beyond).[246] The latter system is not only

[245] See the general comments to the principle of capital export neutrality and the principle of capital import neutrality in chapter 2.

[246] See, for example, the observations outlined in paragraph 27.4 - 27.9 of the Commentary on Article 1 of the OECD-MTC.

economically justified and supported by equity principles, but also shows that the intention of the state which applies such legislation is really the focus on the critical element from an anti-avoidance (anti-deferral) perspective. In other words, the state which applies such an alternative regime makes it clear, in my opinion, that there is no intention to tax (on a current basis) “more than necessary.”[247] It is required, of course, that the basic interest taxation is structured in a way which does not create a “penalty effect” for the investor. Such an alternative system will be outlined in chapter 9.

7.7. Review of Important Aspects and Examination of the Principles Derived from Previous Chapters

From all of the cases examined in this chapter, it is only the *Schneider* Case in which a tax court - in this case the French Supreme Tax Court - concluded that the CFC regime cannot be applied if the double tax convention does not explicitly preserve the application of such a regime. This conclusion, however, was mainly based on the fact that the Supreme Tax Court did not accept, in essence, the distinction between “juridical” and “economic” double taxation (the distinction was considered to be “artificial”). In other words, the purpose of the double tax convention cannot be limited, pursuant to the French Supreme Tax Court, to the avoidance of juridical double taxation, but also encompasses the avoidance of economic double taxation. I have already made it clear that I cannot follow the position of the French Supreme Tax Court. From my perspective, the double tax convention only encompasses international juridical double taxation if the scope is not explicitly extended to international economic double taxation.

The other decisions which were examined in this chapter did not find a conflict between CFC legislation and double tax conventions, i.e. there is no necessity for an express provision in the double tax conventions - concluded between the respective states - which allows the application of CFC regimes. The outcome of these cases is, in principle, in line with the position of the OECD.[248] This, of course, is not particularly surprising since it was used, at least by the Finnish Supreme Administrative Court in the *A Oyj Abp* Case, as an important element in the line of reasoning. In any event, I agree with the (final) outcome of these cases and the position of the OECD that there is no necessity to confirm the application of the CFC rules in a double tax convention. As already outlined earlier, there is no convincing reason, in my opinion, why domestic CFC legislation should be treated differently from any other domestic legislation, just because of the fact that such legislation establishes a link to income which is derived through the interposition of a foreign company. However, the fact that CFC legislation does not have to be preserved in the convention does not necessarily answer the question whether it can finally be taxed in the state which applies the CFC legislation. In other words, there is still the requirement to determine the type of income under the tax treaty in order to clarify whether the state of the shareholder - which applies the CFC taxation - has the right to tax the attributed income. It might be the case, at least theoretically, that the income which is attributable to the shareholder is to be classified - in the context of the tax treaty - as a type of income which can only be taxed in the other contracting state. This might prevent the state of the shareholder from taxing the income (even if the CFC legislation can, in principle, be applied). For this reason, it is interesting to have a

[247] “Necessary” from the perspective of the state which applies such legislation.
[248] The position of the OECD was made clear in the 2003 amendments to the Commentary.

look at the classification in the respective cases: in the *A Oyj Abp* Case, the Finnish Supreme Administrative Court concluded that *"(w)hen determining the character of the (...) income for the purposes of the tax treaty, the starting point must be that this income constitutes business income under art. 1 of the Business Income Tax Act and the tax treaty does not contain any definition of business income, such a definition being derived from national law. Hence, for the purpose of applying the tax treaty, the income has the character of business income.*"[249] In the *Captive Insurance* Cases, the Swedish Council for Advance Tax Rulings considered the attributable income under the CFC regime as business profits of the parent company in Sweden (alternatively: other income).[250] Thus, in both cases the income was classified as business income of the shareholder (the parent company) and - explicitly - not as dividend income. In contrast thereto, the explanations of the Court of Appeal in the *Bricom Holdings* Case remains, in my opinion, too vague: the fact that the interest income received (directly) by the CFC is not included anymore as interest income in the attributable income is fully understandable. However, for tax treaty purposes, it is not sufficient to classify the attributable CFC income as a "purely notional sum." Even such a purely notional sum must somehow be classified in order to determine which state has the right to tax the income. However, it seems that the Court of Appeal did not see the necessity to deal with this question. It might be too apparent that the "chargeable profits" are part of the business profits of the parent company. At least, the income was obviously not considered to be dividend income for tax treaty purposes. The OECD, on the other hand, is not fixed on a certain type of income: it might be business income, dividend income, or other income. In any event, a common element of the *Bricom Holdings* Case, the *A Oyj Abp* Case, the *Captive Insurance* Cases, and the position of the OECD, is the fact that the attributable income according to the CFC regime is not considered to represent any profits of the subsidiary company. Of course, this is - at the same time - the important difference to the conclusion of the French Supreme Tax Court in the *Schneider* Case.

However, the approach of income classification for tax treaty purposes is neither sufficiently clear from the existing case law nor from the position of the OECD. I have outlined in this chapter that there are several arguments against a classification of the attributable income as dividend income - and it seems that the existing case law supports this position. Thus, if one agrees that the attributable income is income of the shareholder which is (i) not identical to the income of the foreign company, and which is (ii) not to be classified as income from shares (dividend income), it seems to me that a logical approach is the focus on the activity of the foreign company - from the perspective of the state of the shareholder - in order to classify the income which is attributable according to the CFC regime. In other words, the activity of the CFC (which is the link for the application of the domestic CFC regime) must be assessed in the light of the tax treaty and, if the type of income cannot be derived from the tax treaty itself, with reference to the domestic legislation of the state which applies the CFC regime. Based on such an approach, the income will most likely be classified as business income of the shareholder, even though it is theoretically also possible, depending on the domestic legislation of the shareholder, for the income to be classified as another type of income, e.g. interest income. However, I have made it clear that even in those cases where the income is not classified as business income, the income taxation in the residence state of the shareholder will usually not be

[249] ITLR, Volume 4, 2002, page 1068.
[250] See Mutén, Council for Advance Tax Rulings Upholds CFC Legislation, Tax Notes International 2005, page 209.

restricted (at least in those cases where the double tax convention follows the lines of the OECD-MTC). The reason is that the classification will be derived from the activity of another taxpayer and this will not cause any international juridical double taxation, but merely an international economic double taxation. The latter, however, is not - as outlined above - within the scope of the OECD-MTC. Further, such an approach of income qualification should not result in a different outcome dependent upon whether the resident shareholder is an individual or a legal entity. The reason is that the qualification should be made, in my opinion, on the basis of the activity of the CFC and is therefore unrelated to the (legal) status of the resident shareholder. Thus, if the income from the provision of loan amounts by the CFC is considered (from the perspective of the state which applies the CFC rules) to be business income, this should be decisive for the qualification described above - no matter whether the resident shareholder is an individual or an entity. In other words, the domestic differentiation in the state of residence of the shareholder between income derived by individuals and income derived by legal entities has no influence on the qualification, because it is the activity of the CFC itself which should be relevant in this respect.

Thus, most of the existing double tax conventions do not prevent the application of CFC rules. The question arises whether this would be different if the legislation were based on the principles derived from previous chapters, i.e. if an alternative legislation were solely focused on the basic interest component. In my opinion, it does not really play a role - in this particular context of double tax conventions - whether the CFC income is completely allocated according to an entity approach, partly allocated according to a transactional approach (horizontal separation), or partly allocated according to a basic interest approach (horizontal and vertical separation). In all of these cases a juridical double taxation does not exist - based on the above reasoning - since it still refers to two different taxpayers. In other words, the fact that the taxation in the residence state of the shareholder should be limited to the basic interest component does not necessarily require any changes of a tax treaty which is based on the OECD-MTC (and which is limited to juridical double taxation). Thus, if a state is willing to follow such a concept of the taxation of the basic interest component, this can be done under the current framework of the tax treaties which are based on the OECD-MTC. On the other hand, if a state prefers to have clarity that the other contracting state does not apply any CFC rules or does not limit the current taxation to the basic interest component, it is required to specifically determine the non-application of CFC rules or the limitation to the current taxation of the basic interest component in the tax treaty.[251] Thus, a “pro-active approach” may result in an amendment to the tax treaty. I will come back to this question in chapter 9 where I am going to present an alternative legislation which is in line with the principles and the requirements identified in this chapter and the previous chapters.

Hence, the basic interest taxation should be in line with tax treaties which are based on the OECD-MTC and which do not explicitly prevent the application of such a concept. The most important aspects in this context are the following:

- The combination of a horizontal and a vertical separation of income results in the safeguarding of competitiveness and comes closer to the principle of capital import neutrality.

[251] Of course, this requires the other contracting state to stick to the principles and the provisions of the tax treaty and avoids any tax treaty override.

- The current taxation of income is strictly limited to the most critical element from an anti-avoidance (anti-deferral) perspective, namely the basic interest component.

- The basic interest taxation does not encompass income which is produced by the CFC itself. This is a clear signal towards the other contracting state to show that the residence state of the shareholder has no intention to tax income (on a current basis) which is produced by the CFC.[252]

- The basic interest taxation does not encompass income which is related to the risk directly covered by the CFC. There is a direct relationship between the positive income related to the risk component (risk premium) and the (subsequent) negative income in case an event arises which is theoretically covered by the risk component, i.e. the risk becomes reality. This, in addition, shows that the residence state of the shareholder accepts the interrelation between the positive and negative income and refrains from taxing the risk component.

- The limitation to the separable financing element results in a clear focus on hybrid structures. The aforementioned core elements of the concept should therefore lead to a greater (general) acceptance among states of the current taxation of income. In my opinion, it is extremely difficult (and clearly more difficult than in case of CFC rules) to argue that the basic interest taxation results in a circumvention of tax treaties.

- The OECD and the EU Council consider CFC / FIF rules to be an important tool to target harmful tax competition. The less restrictive and more target-oriented concept of a basic interest taxation should, from my perspective, be clearly in line with the recommendations included in the OECD Report on Harmful Tax Competition and the EU Code of Conduct.

- The fact that the basic interest taxation should not be restricted by a tax treaty[253] provides the possibility to structure the concept in a way that the income is allocated to the ultimate resident shareholder. In my opinion, this would not only improve the efficiency of the concept but would also be supported by equity considerations.

- The basic interest taxation should be in line with the ability-to-pay principle. This is mainly due to the fact that there is, in principle, no discrepancy between the treatment of positive and negative income, but the taxation is solely limited to the basic interest component (and leaves aside the activity element and the risk element).

[252] As long as the income produced by the CFC is not connected to a permanent establishment in the residence state of the shareholder there will be no income taxation in the latter state. Of course, even in case of a permanent establishment the income produced by the CFC would not be taxed under the basic interest taxation regime but according to the regular income tax regime.
[253] If the tax treaty does not explicitly prevent the application of such a concept.

7.8. Conclusions

1.) Up to now only a few tax courts in Europe have dealt with the question of compatibility of double tax conventions and CFC legislation. However, with the exception of the French *Schneider* Case, the case law which has been examined did not see a conflict between double tax conventions and the application of CFC rules, even if the latter rules are not explicitly preserved in the respective conventions. In the *Schneider* Case, the French Supreme Tax Court concluded that the CFC rules cannot be applied if the application is not expressly confirmed in the French tax treaties. In contrast, the Finnish Supreme Tax Court did not see any conflict in the *A Oyj Abp* Case between the application of the Finnish CFC regime and the Finland-Belgium tax treaty which does not contain any specific provision in this respect. The same is basically true for the decision in the British *Bricom Holdings* Case where the Court of Appeal did not see any restriction for the application of the United Kingdom CFC regime to income derived by a legal entity resident in the Netherlands. The Swedish Council for Advance Tax Rulings decided in two cases - which dealt with captive insurance companies in Luxembourg and Switzerland - that the application of the Swedish CFC regime is not in conflict with the respective tax treaties. Also in the Swedish cases, the double tax convention did not explicitly deal with the applicability of CFC rules.

2.) The position of the OECD is now made clear since the 2003 update of the Commentary. Before the 2003 update, the Commentary solely provided the majority and minority opinions of the Member countries. Pursuant to the OECD, the CFC rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to tax liabilities. These rules are not addressed in tax treaties and are therefore not affected by them. Thus, the OECD does not see, in principle, a conflict between tax treaties and domestic CFC legislation. I agree with the position that CFC rules do not have to be specifically preserved in a double tax convention. Those rules do not have to be treated differently from any other domestic legislation which can be of relevance in the relationship between the respective tax treaty countries. It is not the CFC, i.e. the foreign company, which is taxed in the residence state of the shareholder, but the shareholder is taxed on income derived through the interposition of the CFC. Thus, there are two different taxpayers involved and the tax treaty does not prevent the taxation of the shareholder in the state of residence on income derived through the CFC. In contrast thereto, the CFC itself may only be taxed in the residence state of the shareholder in case of a permanent establishment of the CFC in the latter state.

3.) Furthermore, the OECD takes the position that CFC rules should only be applied to certain passive activities but not to active businesses. As already outlined earlier a separation between “active” and “passive” can be quite difficult. In any case, the OECD considers “base company activities” to be passive activities. In my opinion, this may have the effect that income from business activities is subject to CFC taxation.

4.) Thus, the existing CFC rules are in most cases too broad for a separation of abusive and non-abusive activities, i.e. CFC rules target both, the abusive and the non-abusive relocation of activities to low-tax countries. Therefore, even if the general aim of a double tax convention encompasses, *inter alia*, the combating of international tax avoidance and tax evasion, this must not result in an unrestricted application of CFC rules *outside* the limitations provided by a double tax convention. That means, if the residence state of the shareholder stipulates, in the context of the domestic CFC legislation, a link to the income which is derived by the shareholder through a CFC interposed in the other contracting state, it is required to examine the latter income and to determine the type of income in the light of the respective tax treaty - from the perspective of the residence state of the shareholder. Hence, if the income classification leads to the outcome that the state of residence of the shareholder has the right to tax the income of the shareholder under the respective tax treaty, there is, in principle, no restriction for the application of the domestic CFC legislation. In contrast thereto, if the income classification leads to the outcome that the state of residence of the shareholder does not have the right to tax the income of the shareholder under the respective tax treaty, the application of the domestic CFC legislation will result in a tax treaty override.

5.) As already outlined above, the CFC income has to be categorised in the context of the tax treaty. In my opinion, it is the actual activity carried on by the CFC which has to be examined and which should be the basis for the income qualification of the residence state of the shareholder (the state which applies the CFC legislation). Since the OECD-MTC does not provide for an exhaustive definition of the term "business profits", the domestic definition of the state which applies its CFC rules has to be referred to. If it turns out that the income derived from these activities (e.g. service activities) is to be qualified - from the perspective of the state which applies its CFC rules - as "business profits," the income which is allocable to the residence country of the shareholder may be taxed in the latter country pursuant to Article 7 (1) of the OECD-MTC. Thus, it is important to note that even though the activity carried on by the CFC is to be examined, the qualification is to be made, in my opinion, from the perspective of the state which applies the CFC rules.

6.) The residence state of the CFC, of course, has to make its own qualification of the income derived by the CFC (in contrast to the aforementioned qualification of the income derived by the shareholder through the interposition of the CFC). The approach of the residence state of the CFC, however, is of no relevance, in my opinion, for the qualification of income under the CFC regime in the state of the shareholder. Thus, there are two different states involved which examine the income of two different taxpayers. The qualification of the respective income as "business profits" does therefore not result in a conflict under the respective tax treaty.

7.) It is often suggested that the CFC income is to be qualified - as a whole and in general - as dividend income in the context of the OECD-MTC. One of the main arguments for the qualification as dividend income is the inseparable link between the holding of shares in the foreign legal entity and the CFC income attribution. Furthermore, the definition of the term "dividends" in Article 10 (3) of the OECD-MTC requires an autonomous examination in the context of the tax treaty. Dividends means "*income from shares*" and it seems that the definition also encompasses hidden distributions of profit without any actual outflow of financial means to the shareholder. In my opinion, those arguments do not necessarily require a qualification as dividends (or a deemed dividend) and there are a number of aspects which do not support such a qualification:

- In nearly all countries which apply such legislation, the CFC income is determined according to domestic rules. The income of the foreign legal entity which may be distributed to the shareholder is therefore typically different from (and unconnected to) the attributed CFC income.

- The CFC rules focus on certain types of income and ignore the actual income based on the commercial accounts of the foreign entity. This is particularly true for the transactional approach.

- Although the likelihood that the CFC rules cover the same types of income as the foreign legal entity is higher in case of an entity approach, it is by no means clear that this is the case for a period of more than one year. The (partial) change of activities can lead to the result that the income is subject to CFC taxation in one year but not in another.

- The attribution of CFC income has no influence on the income based on the commercial accounts of the foreign company and it has no influence on the net asset value (in contrast to open or hidden distributions of profit). The company is therefore in a position to distribute all of the profits derived from its activities to the shareholder and this is - and must be - totally unconnected to a CFC income attribution.

- The actual profit distribution of the company leads to income from shares (dividend income) and reflects the added value of the investment. It is by no means comparable to the CFC income attribution - even though they are economically related to the same income.

- It follows from the features and the mechanism of CFC rules outlined earlier that the concept of CFC income attribution is different to the concept of dividend income. The focus on the residence state of the foreign entity and the fact that the term dividend means "*a distribution of profits to the shareholders*" requires - in my opinion - a nexus between the income based on the commercial accounts of the company and the (open or hidden) distributions to the shareholder. It is the (net) profit of the company which is made available to the shareholder by way of profit distribution. In contrast, the CFC rules are very specific and only attribute the income in certain limited and clearly defined situations. This can have the effect that the CFC taxation is not applicable during the entire period of foreign investment but only in years where certain requirements are fulfilled. The application typically requires that (i) a certain participation threshold is exceeded, (ii) a certain low-taxation threshold is *not* exceeded, and (iii) certain income elements are derived by the foreign entity (transactional approach) or a certain mixture of income and / or certain circumstances are existent (entity approach).

8.) The question arises whether the CFC income can still be qualified as "business profits" in case the attributable income also encompasses elements of interest income, royalty income or dividend income. In my opinion, the following separation has to be made:

- If, from the perspective of the state which applies the CFC rules, the income derived by the shareholder through the CFC is to be qualified, in total, as "business profits" - despite the fact that also other elements like interest income, royalty income, and dividend income are included - there is no necessity for any subdivision of the business profits. In other words, it is decisive whether the elements included in the income can result in a different qualification of the respective activity and the respective income. If this is not the case, the whole income is to be qualified as business income. Here, the different elements become an integral part of the business activity and the business income. It can also be described, in my opinion, as an amalgamation of elements which might be, on a "stand-alone basis", separate types of income. The outcome of the qualification should not be dependent upon whether the resident shareholder in the CFC is an individual or a legal entity. The qualification should solely be made on the basis of the activity of the CFC and is therefore unrelated to the (legal) status of the resident shareholder. The domestic differentiation in the state of residence of the shareholder between income derived by individuals and income derived by legal entities has no influence on the qualification, because it is the activity of the CFC itself which should be relevant in this respect.

- As already outlined above, the residence state of the CFC has to make its own qualification of the income derived by the CFC. Here, the residence state of the CFC has to take into account the different types of income for the allocation of taxing rights under the double tax conventions concluded by the latter state (e.g. with respect to withholding taxes) - even though the different income elements may finally also become an integral part of the business income of the CFC from the perspective of the residence state of the CFC (similar to the approach which was outlined above with respect to the residence state of the shareholder).

- If the activity carried on by the CFC is solely limited to a passive activity, such as the deriving of interest income (or dividend / royalty income), and the activity itself does not contain any substantial service element (or any other substantial element of a business activity), the reference to the domestic law of the residence state of the shareholder (the state which applies the CFC rules) might lead to the outcome that the income is to be determined as interest income (or dividend / royalty income) and not as business income. The definition of "interest" included in Article 11 (3) of the OECD-MTC is of no importance in this respect. The latter is only relevant in the context of Article 11 of the OECD-MTC for the allocation of taxing rights related to the gross amount of interest payment (withholding taxation) between the country of source and the country of residence of the CFC (and not the shareholder). Based on the domestic definition of the residence state of the shareholder, the CFC income may be qualified as interest income (dividend / royalty income) for tax treaty purposes. This would also lead to a taxation of the CFC income in the residence state of the shareholder. The different qualification does not restrict the right to tax the income in the country of the shareholder which applies its CFC taxation. This is not only true for interest income but also for dividend income and royalty income.

- The income from immovable property is not equally flexible and subject to disposal of the shareholder, and therefore less often subject to CFC taxation compared to the aforementioned types of passive income, but this does not mean that this type of income is completely outside of the scope of CFC taxation. However, there is a major difference between interest income, royalty income and dividend income on the one hand and income from immovable property on the other: the concept of Article 6 of the OECD-MTC requires a source based taxation of the rental income and is by no means limited to a withholding taxation of the gross amount of income. The taxation is therefore based on a net concept. However, this should not lead to the outcome that the income from immovable property is treated differently from the other types of income outlined above. The CFC rules do not tax the direct owner of the immovable property but the (direct or indirect) shareholder in the company which carries on the rental activities. The classification of income is therefore to be made separately for two different persons by two different states. Hence, Article 6 of the OECD-MTC does not directly restrict the taxing rights of the state of the shareholder. For this reason, a limitation of taxing rights which follows the concept of Article 6 of the OECD-MTC could only be made by analogy. In my opinion, the only justification for such an analogous application might be derived from the concept of a strict source-based taxation of the net income from immovable property, i.e. if both contracting states follow a strict source-based taxation of rental income - not only in relation to each other but also in relation to third states - and the double taxation is avoided solely by the application of the exemption method. In such a situation, it is not only questionable whether a CFC taxation of rental income is actually required from an anti-avoidance perspective, but one might also argue that the application of those rules is in contradiction to the purpose and the idea of the respective tax treaty. However, the OECD-MTC does not provide for an analogous application of Article 6 and I do not see, therefore, any legal basis for such an approach. That means, even the classification of the attributed income as rental income - from the perspective of the residence state of the shareholder - would not restrict the right to tax the attributed income.

9.) The principles are equally relevant for the taxation of capital gains under a CFC regime: if the activity is to be qualified as business activity, the capital gains are part of the allocable business income. In all other cases, the qualification is to be made with reference to the domestic legislation of the country which invokes the respective double tax convention. The wording “*shall be taxable only*” in Article 13 (5) of the OECD-MTC is no obstacle for the taxation of CFC income, because there are two different taxpayers involved.

10.) Based on the argumentation above, there is not much room for the application of Article 21 of the OECD-MTC. However, even if one takes the position that the CFC income attribution falls within the scope of Article 21 of the OECD-MTC, the outcome would not be different. The taxing rights related to other income are allocable to the residence state of the shareholder which applies its CFC taxation.

11.) In my opinion, the qualification of income should not be dependent upon the respective CFC system (entity approach or transactional approach). The domestic methodology of creating a nexus to the income of the CFC and the limitation to certain types of income cannot be of any influence for the qualification of income under the respective tax treaty. If the income has to be qualified pursuant to the actual activity carried out in the CFC country (e.g. business activity), any limitation of the income attribution to a certain part of the net income, e.g. interest income under a transactional system, should not lead to a qualification of the attributable income as interest income instead of business income. Otherwise, it would be the domestic structure of the CFC legislation which is solely decisive for the qualification of the attributed CFC income by the mere fact that it refers to certain income components which are indirectly included in the net income.

12.) In principle, the general application of CFC rules to all types of income instead of a limitation to certain types of income and / or certain circumstances might lead to a circumvention of tax treaties. At least, this might be true in cases where the respective tax treaty otherwise provides for the exemption of dividend income and the income from capital gains on the disposal of shares, and where the application of the CFC regime results in a complete and unrestricted taxation of the whole CFC income. On the other hand, it should not be overlooked that in case of a credit country the main consequence is the immediate taxation of CFC income and the avoidance of tax deferral. The business profits derived by the foreign legal entity are still taxable in the source country and as long as the country which applies the CFC rules provides for a crediting of the foreign income tax an international economic double taxation would be avoided.

13.) The conclusions drawn in this chapter are equally relevant for an alternative regime which is based on the principles derived from chapters 2 and 3, i.e. a regime which focuses on the taxation of the basic interest component. The latter approach does not result in a juridical double taxation - just like the regular CFC regimes. In other words, the basic interest approach would be in line with double tax conventions if the scope of such conventions is not explicitly extended to international economic double taxation.

8. CFC Legislation and European Union Law

8.1. Introduction

In this chapter, the concept of CFC legislation will be examined in the light of the basic freedoms which were outlined in chapter 4 and which may be of particular relevance in the context of the application of CFC rules, i.e. the freedom of establishment, the freedom to provide services, and the free movement of capital. It will be clarified whether the CFC taxation may result in a restriction on the exercising of the aforementioned basic freedoms and whether the appropriate pair of comparison for the identification of such a restriction is limited to a hypothetical domestic investment or whether the comparison may by extended to hypothetical foreign investments in other Member State which do not trigger the application of CFC rules (vertical comparison) and to hypothetical permanent establishments (horizontal comparison). Moreover, it will be verified whether - in case of a restriction on the basic freedoms - there will be any justifications under the rule of reason. In addition to the examinations related to primary EU law, I will also clarify the concept of CFC legislation in relation to secondary EU law. Here, the focus will be on the Parent-Subsidiary Directive and the Interest and Royalty Directive. The examinations will be based on the conclusions drawn in previous chapters where the basic principles have been outlined. Finally, I will briefly outline the dilemma of the Member States with respect to the application of CFC rules, the reaction of some Member States to the outcome of the *Cadbury Schweppes* decision - the first decision of the ECJ which dealt with the application of CFC rules - and the necessity of a “limited” capital export neutrality approach.

8.2. CFC Legislation and Primary European Union Law

8.2.1. CFC Legislation and the Freedom of Establishment

As already outlined earlier, the ECJ defined the concept of establishment in the *Factortame* decision as “*the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period*.”[1] In the following, it has to be examined whether - and under which circumstances - the investment in a CFC in another Member State falls within the scope of the freedom of establishment. The investment in a CFC is to be understood as an investment in a foreign company which fulfils the requirements of the residence state of the shareholder for the application of domestic CFC rules. It is clear from the earlier chapters that the application of these rules usually requires the exercising of certain passive or base company activities[2] or activities which are mainly directed towards related parties outside of the residence state of the CFC.[3] It is therefore important to clarify whether these activities are, in principle, covered by the freedom of establishment or whether they are - in whole or in part - outside of the scope of the latter freedom. Furthermore, the conclusions derived from the earlier examinations, e.g. the necessity of a definite influence over the company’s decisions, will be examined in the context of CFC legislation.

[1] Case C-221/89 (*Factortame II*), paragraph 20.
[2] See the “transactional approach“ outlined in chapter 6.
[3] See the “entity approach“ outlined in chapter 6.

8.2.1.1. Economic Activity

The fact that only economic activities are covered by the freedom of establishment makes it necessary to have a closer look at the activities typically carried on by CFCs. Based on the earlier examinations it seems to be apparent that the mere holding of assets cannot be considered an economic activity. It was outlined in chapter 4 that such a holding of assets must be accompanied by an income-producing activity in the respective state - even if the income-producing activity is only of minor overall importance, e.g. within a group of companies. On the other hand, the mere artificial "creation" of a foreign activity without any substance would often not be in the focus of CFC taxation. In the latter case, the artificial foreign activity would be considered to take place in the state where the activities are actually carried out.

8.2.1.1.1. Holding and Portfolio Activities

If the sole purpose and actual activity of the foreign legal entity is literally the *holding* of assets, and nothing else, this should not be within the scope of the freedom of establishment since it cannot be considered an economic activity. This is, in my opinion, not self-evident but requires further clarification. The point is that the holding of assets itself is not free from risks; or from another perspective: the risks related to the assets held by the foreign legal entity are - in the absence of any other accompanying activities - the only economically decisive factor. In those cases, the investment risks related to the assets are shifted to the state of the CFC and encompass, in particular, the change in value of the investments. This, by itself, might be an important element within, for example, a group of companies. However, it should be clear from the earlier examinations of the case law of the ECJ that the assets must be utilised to pursue an economic activity, and can only be seen as an *instrument* for pursuing an economic activity.[4] The risks which are inherent in the holding of assets cannot, therefore, be seen as a decisive factor for the qualification as an economic activity in the sense of the freedom of establishment - if it is not accompanied by an income-producing activity in the respective state. But what does that actually mean? The implementation of a holding company in another Member State which can only be seen as a conduit company for the holding of shares in other companies and which does not carry out any additional functions cannot be covered by the freedom of establishment.[5] This should be true for majority shareholdings, minority shareholdings and the investment in bonds and similar portfolio investments.

The outcome may be different if the foreign holding company (the CFC) fulfils additional functions, i.e. in addition to the mere holding of assets. Only in such a situation can the activity be seen as an economic activity. There is no doubt, from my perspective, that a holding company itself can, in general, rely on the right of establishment or that a holding company can be used as a "vehicle" to claim - directly or indirectly - the right of establishment.[6] However, in the direct relationship between the Member State of the shareholder and the Member State of the holding company, it is decisive that the activity of the holding company is to be classified as an economic activity. Here, it is the shareholder who exercises his right of establishment

[4] See the examination in chapter 4, especially related to the *Factortame* and *Jaderow* case.
[5] Alternatively, the investment can be in the scope of the free movement of capital, but this will be examined separately later on.
[6] See the examination in chapter 4, especially related to the *ICI* case.

through the establishment of a holding company in another Member State. Thus, if the holding company provides services to, for example, subsidiary companies, this may very well be considered to be an economic activity of the holding company. This is especially true if the holding company is involved in the management of the subsidiary companies and provides financial services to the subsidiary companies. In case of portfolio investments, the active and professional management of the investments - and therefore the exercising of an income-producing activity in the state of the CFC - can lead to an economic activity.

8.2.1.1.2. Investment Management Activity vs. Economic Activity?

Especially in case of CFC legislation it is important to clarify whether investment management activities can, in general, be seen as economic activities or whether these activities have to be seen as (other) activities which are outside of the scope of the freedom of establishment. This question might come up if the foreign legal entity does not exercise all of the functions which are necessary for the activity to be considered clearly and in its totality as a “professional” investment management activity, i.e. in those cases where the functions carried out by the CFC are rather limited. As already stated earlier, it is often the case that the capital investment is the prevailing purpose - and therefore the prevailing activity - of the CFC, and the accompanying services are of minor importance. This may lead to a strong dependency of the CFC from the domestic shareholder (parent company). However, this does not mean that the CFC itself is not able to carry on its (limited) activities or that the business as such cannot be seen as a self-contained activity, but it might lead to the result that additional services have to be received from the parent company and significant decisions are influenced by the parent company. However, this should be in line with the concept of establishment. In my opinion, this can be understood from the *Factortame* decision. In the latter case, the ECJ considered a “*decision taking centre*” located in the Member State of the principal establishment not to be contrary to the right of establishment.[7] The dependency from a management point of view - either by management decisions or by the receiving of services - should therefore not be particularly problematic for the classification as an economic activity. That means the limitation of functions exercised in the CFC country is, as such, in line with the right of establishment. Of course, this does not answer the question whether the (limited) investment management activities may be seen as economic activities. In this respect, it should be clear that any domestic separation of the Member States between investment management activities and business activities - which can also be based on the concept of an economic activity - does not play any role in the context of the freedom of establishment. Here, it seems to be important that a certain “economic output” is produced in the state of the CFC and it does not really matter whether this output is related to an investment management activity or a business activity. This becomes more obvious below.

8.2.1.1.3. Inter-Company Activities

Inter-company service activities are not only one of the main targets of CFC rules, but are also of great significance for multinational enterprises.[8] In my opinion, it is worth dealing with the inter-company activities separately from the holding and portfolio

[7] Case C-221/89 (*Factortame II*), paragraphs 34 and 35.
[8] Sometimes it is not restricted to inter-company services but also encompasses inter-company trading activities (e.g. in Germany).

activities outlined above. What is meant here are the capital intensive activities which are relocated from the Member State of the principal establishment to other Member States, namely financing activities (e.g. cash pooling), leasing and rental activities, licensing activities, and any other similar intra-group service activities. Leaving aside the tax aspects for a moment, it is from an economic point of view the separation and allocation of functions among different legal entities in different states. For example, if a leasing company is incorporated in Member State C which is now responsible for the investment in machinery and the renting out to the production companies in other Member States, nobody would seriously question the economic activity in its totality, i.e. the production and sales activity of the group. This raises the question whether it is justified to separate a single fraction of the whole activity - the secondary establishment of a leasing company in Member State C - and to qualify this activity differently. Or is it not rather necessary to see the leasing activity in the context of the complete business activity of the group? Without any doubt, the right of establishment plays are role in the relationship between the Member State of the principal establishment and the Member State of the secondary establishment, but this does not necessarily answer the question whether the overall context is decisive or not. In my opinion, it would not be helpful to start qualifying each and every activity without taking into consideration the overall picture. Only the overall picture provides the possibility for an appropriate categorisation of any activity. It is therefore unlikely, in my opinion, to end up in the aforementioned example of a leasing company with anything other than an economic activity. Again, this should be true even for minor functions, as long as it is not solely limited to the holding of assets. The performance of additional functions is part of the complete business activity and fulfils a certain purpose within the overall activity. It must be repeated at this point that there is basically a small borderline between the acceptance of the performance of very limited functions in the CFC country (in addition to the holding of assets) and the qualification by one of the Member States - normally the Member State of the principal establishment - as an abusive structure. However, if the decision is made that the very limited activity is performed in the CFC country and that there is no situation which must be considered abusive and no situation where the effective place of management has to be considered to be in the country of the shareholder (parent company), the activity as such is to be accepted. In this case, the functions exercised in the CFC country are part of the overall economic process of the group. Otherwise, the different categorisation would be solely dependent upon the decision whether the activity remains connected to other activities within a certain country which are indisputably considered an economic activity, or whether the activity is separated and relocated to a Member State where the group does not carry on any other activity. The German domestic case law with respect to the concept of "business separation" may be referred to in this context. Pursuant to this concept, certain activities are considered to be business activities, even though they would normally be seen - on a stand-alone basis - as investment management activities or other activities pursuant to domestic law. The reason is that under certain circumstances the other activity may not be qualified differently from the business activity. If, for example, a person holds the ownership in certain tangible or intangible assets which are rented out to a company in which this person is the main shareholder, the rental income will be determined as business income. However, this requires that the assets used can be seen as essential assets for the company using the assets. This concept avoids a different qualification of activities by simply separating the activities. Clearly, this approach cannot be transferred directly to the "economic activity" under the right of establishment, but it is an example for a general concept which does not consider activities isolated from each other. In my opinion, the same should be true in the context of the right of establishment, even if it refers to functions of minor importance. The concentration on substantial services may be helpful in a domestic situation, e.g. for simplification reasons, but it would not be an appropriate element for a differentiation under the right of establishment.

The first case in which the ECJ had to deal with CFC legislation and the provision of inter-company services was the *Cadbury Schweppes* case.[9] In this case, the question whether the financing services provided by the CFC could be seen, in general, as an economic activity was obviously not considered particularly problematic. In this respect, Advocate General Léger outlined in his Opinion to the case that *"(...) 'establishment', within the meaning of Article 43 EC et seq, involves the actual pursuit of an economic activity in the host State. If the subsidiary is actually carrying on such an activity in that State and, in that connection, it provides genuine and actual services to the parent company, I do not think that that situation may be regarded, in itself, as tax evasion or avoidance, even if payment for those services leads to a reduction in the taxable profits of the parent company in the State of origin. Having regard to the objective of the freedom of establishment, as long as the subsidiary carries on genuine economic activity in the host State, there is no difference between the provision of services to third parties and the provision of those services to companies belonging to the same group as the subsidiary. In addition, the provision of services by a subsidiary to its parent company is an economic activity which takes the form of transactions between distinct legal persons. The fact that those companies are linked does not prevent the pricing of those transactions from being determined under normal competitive conditions. (...) Transactions between a CFC and its parent company which result in reducing the taxable profits of the latter can therefore be regarded as tax avoidance only if the establishment of that subsidiary and those transactions constitute (...) a wholly artificial arrangement aimed at circumventing national law. Likewise (...) the fact that a company centralises in another Member State with a low tax rate the carrying on of certain activities of use to the entire group and seeks by that means to reduce the group's overall tax burden does not in itself constitute abuse. In such a case, as long as the subsidiary responsible for those intragroup services is carrying on genuine economic activity in the host State, under the tax sovereignty of which it falls, the territorial allocation of the Member States' power to impose taxes is not, a priori, affected. The loss of taxable profits affecting the State of origin is the result of the economic activity which is carried out in the host State and taxed by that State."*[10] Interestingly, the ECJ itself did not really go into detail of the question of economic activity, but rather concentrated on other questions, such as the abuse of the freedom of establishment and the separation from wholly artificial arrangements. For this reason, the decision does not provide any further information on the differentiation between economic activities and other (non-economic) activities. At least, it seems that the ECJ did not see any problem in classifying the inter-company finance activity as an economic activity and, thus, apparently followed the position of the Advocate General.

Hence, it seems that there is no doubt about the fact that a CFC may carry on an economic activity by providing services to the parent company or any other related party. Even though the case itself only encompasses financing services, there is no reason, in my opinion, to assume that the outcome would be different in case of

[9] Case C-196/04 (*Cadbury Schweppes*).
[10] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 106 to 109.

leasing, renting, licensing or similar services. The latter services may even create a higher economic output in the CFC state than the mere financing services. The reason is that - in a typical situation - more functions have to be carried out in the CFC state in case of leasing, renting and licensing services than in case of mere financing services (this can be different, of course, in case of cash pooling and similar services).

The above position is supported, in my opinion, by additional case law. In the *Columbus Container* decision,[11] a case which dealt with a provision of the German *Außensteuergesetz* which is linked to the CFC rules, a Belgian limited partnership was responsible for the coordination of activities of a group of companies (Belgian coordination centre). The services covered, in particular, the centralisation of financial transactions and of the accounts, the financing of the liquidity of subsidiaries or branches, the computerisation of data and advertising and marketing activities.[12] Almost all of the income of the coordination centre was considered to be passive income under the respective German legislation.[13] Also in this case, the ECJ did not see any necessity to deal with the question of economic activity.

8.2.1.2. The Separation from Wholly Artificial Arrangements

In his Opinion to the *Cadbury Schweppes* case Advocate General Léger proposes a case-by-case examination which has to be made for the separation of genuine economic activities which are carried on in the host Member State and wholly artificial arrangements which are merely intended to circumvent national legislation.[14] In this respect, he follows to a large extent the criteria which were proposed by the Commission and the United Kingdom. The focus should therefore be on three criteria which are of particular relevance: (i) the degree of physical presence of the subsidiary in the host State, (ii) the genuine nature of the activity provided by the subsidiary, and (iii) the economic value of that activity with regard to the parent company and the entire group.[15]

a.) The degree of physical presence of the subsidiary in the host State

According to Advocate General Léger, the first criterion relates to the question whether the subsidiary company is "(...) *genuinely established in the host State*." This means "(...) *examining whether the subsidiary has the premises, staff and equipment necessary to carry out the services provided to the parent company which have resulted in the reduction of the tax due in the State of origin. If that is not the case, the subjection of those services to the tax sovereignty of the host State does appear to be a wholly artificial arrangement designed to avoid tax.*"[16] Hence, the subsidiary must be capable of providing the services in question from within the host Member

[11] Case C-298/05 (*Columbus Container*). See with respect to the *Columbus Container* decision also Rainer, Columbus Container: Belgisches Koordinierungszentrum und AStG, Internationales Steuerrecht 2008, page 63 et seq.; Franck, § 20 Abs. 2 AStG auf dem Prüfstand der Grundfreiheiten – Anmerkung zu den Schlussanträgen des Generalanwalts Mengozzi in der Rechtssache C-298/06 (Columbus), Internationales Steuerrecht 2007, page 489 et seq.; Thömmes, Übergang zur Hinzurechnungsmethode bei Betriebsstätten EG-rechtskonform, Internationale Wirtschafts-Briefe 2008, page 1169 et seq.
[12] Case C-298/05 (*Columbus Container*), paragraph 15.
[13] Case C-298/05 (*Columbus Container*), paragraph 16.
[14] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 110.
[15] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 111.
[16] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 112.

State. However, as already outlined earlier, this does not necessarily require, in my opinion, that the subsidiary cannot be directed and controlled from the parent company or cannot be the recipient of services provided by the parent company, but from the overall picture it must be clear, in my opinion, that the respective (intra-group) functions are physically carried out by the subsidiary company within the host Member State.

b.) The genuine nature of the activity provided by the subsidiary

This is described by the Advocate General as *"(...) a question of looking at the competence of the subsidiary's staff in relation to the services provided and the level of decision-making in carrying out those services*." If it turns out that *"(...) the subsidiary proves to be nothing but a mere tool of execution because the decisions necessary to carry out the services it is paid for are taken at another level, it is also right to consider that the subjection of those services to the tax sovereignty of the host State constitutes a wholly artificial arrangement*."[17] In contrast to the first criterion which is related to the physical presence in the host Member State, the second criterion requires the "presence of decision-making." Again, this does certainly not mean that the subsidiary is completely uninfluenced by the parent company, but it might be understood in a way that the decisions which are related to the provision of the services are actually taken by the responsible staff in the host Member State.

c.) The economic value of that activity with regard to the parent company and the entire group

The third criterion is, pursuant to the Advocate General, related to the value added by the subsidiary's activity. This requires that the activities of the subsidiary are of "*use*" to the entire group.[18] This is not the case if the services provided by the subsidiary "(...) *have no economic substance in the light of the parent company's activity. If that were the case, I think it can be accepted that there is a wholly artificial arrangement because there appears, in effect, to be no consideration for the payment by the parent company for the services in question. Payment for such services could therefore be viewed quite simply as a transfer of profits from the parent company to the subsidiary*."[19] It seems to be clear from the statement of the Advocate General that the lower taxation *itself* is not sufficient to be considered an "*added value*" to the entire group.[20] It is obvious that the separation between objectively useful services and those which are not objectively useful may be quite difficult. However, it can be assumed that the centralisation of activities which are usually in the scope of CFC taxation will most often have to be considered useful, at least in those cases where the services are not only related to the parent company but to a number of related companies and where certain synergy effects can be achieved. This is particularly true if the overall costs (e.g. for staff, premises) are lower than in the state of the parent company (other subsidiary companies). Of course, if one follows such a criterion, the argumentation with respect to an "added value" becomes difficult if the services are only provided to the parent company and, for example, the overall costs

[17] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 113.
[18] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 109: the Advocate General refers to "*certain activities of use to the entire group*."
[19] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 114.
[20] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 109.

are higher in the Member State of secondary establishment compared to the Member State of primary establishment and if no other important reasons exist which support the investment decision. In my opinion, this does not mean that the payments made by the parent company cannot be seen as a consideration for the services provided, but the decision is not supported by economic principles or any other important reasons. The structure is therefore solely based on tax advantages (which - in such a case - apparently exceed the economic disadvantages). Nonetheless, I think the third criterion can only be considered in the overall context - together with the other criteria - and the establishment has to be assessed in its totality.

d.) The decision of the ECJ

It is important to note, however, that in the decision itself the ECJ only referred, in essence, to the first criterion and not (explicitly) to the second criterion and the third criterion. The ECJ outlined that *"(...) in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality. That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State (...). As suggested by the United Kingdom Government and the Commission at the hearing, that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment. If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a 'letterbox' or 'front' subsidiary."*[21]

Without any doubt, there is an important difference between an approach which solely focuses on the first criterion compared to an approach which focuses on the three criteria described by the Advocate General - based on the suggestion of the United Kingdom Government and the Commission. In my opinion, it is logical to concentrate on objective factors such as the physical existence in terms of premises, staff and equipment. If it turns out that the CFC does not carry out *any genuine economic activity*, it must be seen as a wholly artificial arrangement. The fact that the ECJ refers to letterbox or front subsidiaries shows, in my opinion, that the intention of the Court is to exclude exactly those arrangements where there is *no* genuine economic activity (in contrast to a low degree of economic activity). The latter aspect is important, because the second criterion and the third criterion do not necessarily exclude any economic activity in the host Member State. For example, the second criterion considers an arrangement as wholly artificial if the CFC is "*a mere tool of execution*." This, however, is problematic: the direct influence of, for example, a parent company in another Member State on the decisions of the CFC should not necessarily result in the classification as a wholly artificial arrangement as long as the CFC carries out the services (physically) in the host Member State (i.e. executes the services). It is clear from *Factortame* that decisions can be taken in another Member State without being outside of the scope of the freedom of establishment. Thus, if the first criterion is fulfilled, i.e. services are physically carried out in the host Member State on the premises of the CFC with its own staff and equipment, it is difficult, in my

[21] Case C-196/04 (*Cadbury Schweppes*), paragraphs 65 to 68.

opinion, to regard it as a wholly artificial arrangement on the basis of the degree of decision making in the host Member State. The third criterion is equally critical, because being of "use" for a multinational group does not say anything about the economic activity in the CFC state. In other words, there may be an economic output in the CFC state (pursuant to an isolated consideration) even though the activity as such - in the whole context - does not lead to an added value. The 'three criteria approach' suggested by the Advocate General also builds a bridge - if it were applied by the ECJ in cases dealing with direct taxation - to the more recent case law of the ECJ with respect to VAT. In the *Part Service* decision the ECJ considered the respective structure to be abusive - despite the existence of economic objectives.[22] Transferred to CFC legislation, the structure could - as a consequence - be considered artificial even if an economic activity is carried out be the CFC. However, as already outlined in chapter 4, I do not see that the case law with respect to direct and indirect taxation is completely aligned in this respect. From my perspective, there are no indications from the case law of the ECJ with respect to direct taxation which support a deviation from the necessity of a 'wholly artificial arrangement which does not carry out any genuine economic activity in the host state'. However, I will come back to this question (and the *Oy AA* case) in section 8.2.5.7.

However, even if the focus is on all of the three criteria and not only the first criterion, it is likely, in my opinion, that the typical intra-group service companies of multinational groups will not be identified as artificial arrangements since they usually fulfil the criteria. The same is true for any other type of capital intensive activities. I think it is also clear that one should not only concentrate on economic reasons for the investment, but also on other important reasons which might be relevant for a relocation of activities to other countries and which might prevail - from the perspective of the investor - over economic principles, e.g. a more favourable legal environment. However, those verifications (or similar verifications) have often already been carried out by the tax authorities of the Member States for the question whether the CFC rules are applicable or not. It was outlined earlier that, for example, such a separation was already required for German tax purposes under the "pre-Cadbury legislation" and, in this regard, the German approach is similar to the approach described by Advocate General Léger. The reason is that the CFC rules can only be applied to income actually derived by a foreign legal entity, and this requires the foreign legal entity to carry on a genuine activity in the respective state. If this is not the case, the income is either directly allocable to the domestic shareholder, since the legal entity is "ignored" (e.g. in case of a letterbox company), or the effective place of management of the legal entity is considered to be in Germany (e.g. if the management decisions are actually made in Germany and not in the other state). In both cases, the CFC rules are not applicable. The very purpose of CFC regimes is therefore the taxation of "real income" from genuine activities derived in the host state. In other words, if the services are not wholly artificial, they should not be subject to CFC taxation. However, if the services are wholly artificial, they will often not be subject to CFC taxation, either, because this situation might result in the taxation of the income - which was artificially allocated to the CFC - in the state of the shareholder.

[22] Case C-425/06 (*Part Service*), paragraph 62.

e.) Reactions in international tax literature to the *Cadbury Schweppes* decision

There are a substantial number of articles dealing with the *Cadbury Schweppes* decision and it might be of interest, in this context, to refer to some of the reactions in international tax literature.[23] Hume, for example, concluded that a reasonably high level of abuse is required for CFC rules to apply in an intra-EU context and therefore possibly only a *very low level of economic activity* would be necessary in the CFC state to avoid the application of the CFC rules.[24] For Ronfeldt, Vinther and Werlauff the CFC rules should be applicable if moveable income is transferred artificially to the CFC, which is not actually existent in the CFC state, i.e. which is merely a "*brass plate, a mail box, or a desk drawer*."[25] From Evans and Delahunty it can be understood that the activity should go *beyond the mere formal registration* in the CFC state.[26] Malherbe et al. concluded that, to comply with the freedom of establishment, CFC rules can only be applied to artificial constructions which are "*tantamount to abuse of law*."[27] Tomsett concluded that the decision may result in a significant narrowing of the scope of the CFC legislation of the Member States.[28] For O'Shea it is highly likely that the United Kingdom CFC legislation has to be "*radically overhauled*" as the motive test is not in line with the requirements of the ECJ, i.e. is not limited to wholly artificial arrangements. He further stated that the Member States now had to come up with more proportionate CFC rules. In this respect, the fact that the ECJ uses the word "*wholly*" within its definition and the acceptance that tax mitigation is legitimate with the Internal Market through the use of the fundamental freedoms will cause, according to O'Shea, further problems for the Member States.[29] A similar conclusion was drawn by Whitehead who held that neither the United Kingdom's CFC rules nor the CFC rules of other Member States - which do not have comparably extensive exemption provisions - can meet the ECJ requirements.[30] He also identified the point that if the resident subsidiary is not actually resident in the other Member State, its management is conducted from within the Member State of the parent company in the UK, its establishment in the other Member State is 'fictitious' and carries out no economic activities there, it should be a UK resident taxpayer anyway. In other words, the fact that the subsidiary is a CFC in the first place and therefore resident beyond the UK might seem to imply a sufficient level of establishment to meet the Court's test for exemption.[31] Rainer et al. also identified that the decision may not only have implications for further CFC cases in the UK, but also for other Member States which apply such legislation.[32] The latter was stressed by Morgan and Bird, too. They further pointed out that the decision could be a

[23] See the overview of tax literature to the *Cadbury Schweppes* decision in chapter 4.
[24] Hume, Cadbury Schweppes - Implications for U.K. Corporates, Tax Planning International Review 2006.
[25] Ronfeldt / Vinther / Werlauff, CFC Rules Go Up in Smoke - With Retroactive Effect, Intertax 2007, page 45 et seq. (47).
[26] Evans / Delahunty, E.U. Perspective on U.K. CFC Rules, Tax Planning International Review 2007.
[27] Malherbe et al., Controlled Foreign Corporations in the EU After *Cadbury Schweppes*, Tax Management International Journal 2007, page 607 et seq.
[28] Tomsett, ECJ Rules UK CFC Legislation Contrary to EC Law, Intertax 2007, page 575.
[29] O'Shea, The UK's CFC Rules and the Freedom of Establishment: Cadbury Schweppes Plc and its IFSC Subsidiaries - Tax Avoidance or Tax Mitigation?, EC Tax Review 2007, page 13 et seq. (32, 33).
[30] Whitehead explicitly referred to Sweden and Germany (see Whitehead, Practical Implications Arising from the European Court's Recent Decisions Concerning CFC Legislation and Dividend Taxation, EC Tax Review 2007, page 176 (181).
[31] Whitehead, Practical Implications Arising from the European Court's Recent Decisions Concerning CFC Legislation and Dividend Taxation, EC Tax Review 2007, page 176 (181). See also Whitehead, What's Your Motive?, Taxation 2006, page 682 et seq. (684).
[32] Rainer et al., ECJ Restricts Scope of CFC Legislation, Intertax 2006, page 636 et seq. (638).

starting point for changing the UK CFC rules and provides an opportunity to make the UK more (and not less) attractive for business. Morgan and Bird proposed to think about the Dutch concept of an 'interest box' regime which might be a "*win-win*" situation for taxpayers and government.[33] Hahn, who was dealing in an article with the possible impact on the German CFC rules, stated that there might remain an "*intersection*" of the requirements determined by the ECJ and the application of the German CFC rules. This should be the case if there was no economic activity, especially in case of pure asset management. However, pursuant to Hahn, the 'activity catalogue' of the German (transactional based) CFC rules cannot be upheld.[34] In my opinion, and this was outlined above in some more detail, the exception for asset management activities seems to be mainly restricted to the mere holding of assets. Kraft and Bron - who also examined the German CFC rules in the light of the decision - came to the conclusion that any remaining possible doubts about conformity with EU law were swept away: the German CFC rules can (factually) not be applied anymore. There is an immediate need for action of the legislator, but a very limited scope for action remains. According to Kraft and Bron, "*the death bells are ringing*" for the German CFC rules.[35] A very similar conclusion was drawn by Thömmes and Nakhai.[36] In essence, the prevailing view in international tax literature seems to be that there is not much room left for the "old type" CFC legislation within the EU. I fully agree with the prevailing view and believe that the lessons from *Cadbury Schweppes* should go beyond the implementation of the minimum adjustments required by the decision in order to comply with EU law, but should finally lead to a legislation which brings together all of the important elements identified in previous chapters. This is, most of all, the non-discriminatory combination of a horizontal and vertical separation of income instead of a mere horizontal separation of income.

8.2.1.3. Fixed Establishment in Another Member State

Based on the earlier conclusions, the concept of branch, agency or other establishment requires a place of business which has (i) the appearance of permanency, (ii) a management, and (iii) the appropriate equipment for the performance of functions in the respective Member State of secondary establishment.[37] In the *Cadbury Schweppes* case, the Advocate General outlined that a subsidiary company must be genuinely established in the host Member State and must have the premises, staff and equipment which is necessary to carry out the services provided.[38] Whether a CFC may fulfil these conditions strongly depends, of course, on the relevant facts and circumstances. However, in a typical situation the activity of an intra-group service company is structured in a way that the functions are

[33] Morgan / Bird, Landmark Decision in the *Cadbury Schweppes* Case, The Tax Journal 2006, pages 7, 8.
[34] Hahn, Bemerkungen zum EuGH-Urteil "Cadbury Schweppes", Internationales Steuerrecht 2006, page 667 et seq. (669, 670).
[35] Kraft / Bron, Implikationen des Urteils in der Rechtssache "Cadbury Schweppes" für die Fortexistenz der deutschen Hinzurechnungsbesteuerung, Internationales Steuerrecht 2006, page 614 et seq. (620).
[36] Thömmes / Nakhai, Ende der Hinzurechnungbesteuerung in Europa, Internationale Wirtschafts-Briefe 2006, Fach 11A, page 1065 et seq. (1070); see in this respect also Thömmes, Vereinbarkeit der britischen Hinzurechnungsbesteuerung mit Gemeinschaftsrecht, Internationale Wirtschafts-Briefe, Fach 11A, page 1019 et seq.
[37] See case 33/78 (*Somafer*); Kemmeren, Principle of Origin in Tax Conventions - A Rethinking of Models, page 174.
[38] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 112. See with respect to the actual establishment of a CFC in the other state also Evans / Delahunty, E.U. Perspective on U.K. CFC Rules, Tax Planning International Review 2007.

performed in the country of establishment for an indefinite period of time. The appearance of permanency should therefore not be an issue. The existence of a management for the exercising of the relevant functions has to be seen in relation to the respective activity, i.e. the performance of rather simple inter-company services certainly requires less management capacity in the Member State of secondary establishment than extensive production and sales activities. The same is basically true for the equipment of the company to provide the services. Thus, it is of utmost importance that the economic activity is clearly connected to a fixed place of business in the country of secondary establishment, even though the activity itself may be supported by the parent company situated in the Member State of principal establishment. According to Evans and Delahunty, a nexus to the Member State of residence of the CFC is required which goes beyond the *mere formal registration*. However, if there is such a nexus - through the pursuance of an activity which goes beyond the mere formal registration - the freedom of establishment should be engaged.[39]

8.2.1.4. The Shareholding in the CFC

It is clear from the case law outlined in chapter 4 that not each and every shareholding in a company established in another Member State comes within the scope of the freedom of establishment. It is required that the shareholding confers a definite influence on the company's decisions and allows the shareholders to determine its activities.[40] Pursuant to the ECJ, this is "*self-evidently always the case wherever there is a 100% holding*."[41] I have already made it clear that, in my opinion, the expressions "*definite influence over the company's decisions*" and "*allows the shareholders to determine its activities*" have to be seen in the light of the commercial and company law of the respective Member State.[42] However, this does not exclude, in my opinion, the possibility of a definite influence on a factual or contractual basis. To be more precise: definite influence can be derived from the domestic law of the Member State in question and may normally be determined by the percentage of shareholding or the voting rights (in case the voting rights differ from the percentage of shareholding). If the voting rights are not sufficient to formally influence the decisions, there may still be the possibility of a definite influence on another basis, e.g. contractual relationships. Furthermore, the ECJ obviously not only focuses on "control" but considers "management" as a factor which may be equally decisive for the overall assessment. In the *ICI* case the ECJ described control *or* management (and not control *and* management) as relevant factors for the exercising of the right of establishment. The case law shows that the ECJ does not formally consider the position of each shareholder involved in the transaction but takes into account the complete transaction. For example, *ICI* had a shareholding in the intermediate holding company - through which *ICI* exercised its right of establishment[43] - of 49 percent. In the X and Y case, two Swedish resident individuals owned together less than 100 percent in a Belgian company.[44] Even though the ECJ left it up to the referring court to ascertain whether there was actually a definite influence on the

[39] Evans / Delahunty, E.U. Perspective on U.K. CFC Rules, Tax Planning International Review 2007.
[40] See case C-251/98 (*Baars*), paragraph 22; case C-208/00 (*Überseering*), paragraph 77; case C-436/00 (*X and Y*), paragraph 37.
[41] Case C-251/98 (*Baars*), paragraph 26.
[42] See in this respect also Advocate General Alber in his Opinion to the *Baars* case, paragraph 33.
[43] See case C-264/96 (*ICI*), paragraph 30.
[44] The remaining percentage was held by a Maltese company. The Swedish residents X and Y did not have any proprietary interest in the Maltese company (see case C-436/00 (*X and Y*), paragraph 15).

company's decisions, it shows again that a shareholding of less than 50 percent - related to one single shareholder - does not *per se* lead to an exclusion from the right of establishment. In the *Überseering* case the ECJ made it clear that the foreign investment of two German nationals - who were the sole shareholders of *Überseering B.V.* - is covered by the right of establishment.[45] It is very clear from *Überseering* that not the single shareholder (and its percentage of voting rights or shareholding) has to be referred to but the constellation has to be assessed in its totality.[46] In the *SGI* case, the shareholding was only 34 percent and it seems that this was already sufficient as such - i.e. without considering the fact that there was also a link on management level - to fulfil the requirement of a definite influence on the company's decisions.[47] In the *Columbus Container* decision eight family members held - directly and indirectly through a German partnership - all shares in a Belgian limited partnership. It can be understood from the case that the direct participation of each family member was 10 percent plus an indirect participation of (all or some) family members - through the German partnership - which was not completely clear from the case.[48] However, since the German partnership held 20 percent in the Belgian limited partnership (in total), the percentage of participation - at least for some family members - should be between 10 percent and 12.50 percent (maximum). It is also clear from the case that decisions concerning the Belgian limited partnership were taken through the same representative at the general meeting.[49] Thus, an individual shareholder may rely on the freedom of establishment - even with a relatively small percentage of shareholding - as long as the majority of shareholders have the same - combined - interest and the shareholders are in a position to have definite influence on the company's decisions. I do not see any reason why this general conclusion should not be transferred, without reservation, to the investment in a CFC.

8.2.1.5. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

It is the conclusion from previous chapters that the current taxation of income should be limited to the basic interest component. However, it is obvious that the requirements in order to come within the scope of the freedom of establishment are not identical to the requirements for the application of a system which is based on the current taxation of the basic interest component. In other words, the latter system can be applicable also in those cases in which the freedom of establishment is not affected. This is mainly due to the following reasons:

- The current taxation of the basic interest component does not necessarily require a definite influence on the company's decisions. From a theoretical perspective, the system should be applied irrespective of the degree of influence and the percentage of shareholding and / or voting rights. A minimum participation may only be supported from an administrative

[45] Case C-208/00 (*Überseering*), paragraph 7.
[46] The ECJ stated that *"(…) it must be borne in mind that as a general rule the acquisition by one or more natural persons residing in a Member State of shares in a company incorporated and established in another Member State is covered by the Treaty provisions on the free movement of capital, provided that the shareholding does not confer on those natural persons definite influence over the company's decisions and does not allow them to determine its activities*" (case C-208/00 (*Überseering*), paragraph 77).
[47] Case C-311/08 (*SGI*), paragraphs 34, 35.
[48] Case C-298/05 (*Columbus Container*), paragraph 14.
[49] Case C-298/05 (*Columbus Container*), paragraph 31.

perspective, but is neither required nor supported from an economic or equity perspective.

- The current taxation of the basic interest component requires the CFC income to contain a separable financing element which is taxed in the residence state of the CFC. Such a situation was identified to be critical from an anti-avoidance perspective. For this reason, the basic interest component which is related to the latter financing element should be, in my opinion, in the focus of any efficient anti-avoidance legislation which is based on the concept of a current taxation of income. However, for the application of the system of current taxation it should not really matter whether the activity of the CFC is to be qualified as an “economic activity” or as any other type of activity as long as the financing element is actually subject to taxation in the CFC state and is not subject to immediate taxation in the state of the shareholder (e.g. because of the fact that the effective place of management is considered to be in the state of residence of the shareholder). In this case, the actual situation is decisive and not just the mere theoretical classification of the activity.

- Similar aspects are relevant for the term “fixed establishment” and “indefinite period.” Although this will most certainly not play a role for an investment in a CFC, it must be noted that the actual qualification under the legislation of the states involved does not necessarily have to comply with the meaning under the freedom of establishment.

Thus, the investment in a CFC does *not necessarily* fall within the scope of Article 49 of the TFEU. As a consequence, there may be no protection under the freedom of establishment in case of the “typical” CFC taxation according to chapter 6. The same can be true for an alternative system which focuses on the current taxation of the basic interest component, e.g. if the alternative system is applied to minority shareholdings.

Moreover, it is important to note that if an alternative system which focuses on the current taxation of the basic interest component falls within the scope of Article 49 of the TFEU, it may still be the case that the application of such a system results in an (unjustified) restriction on the freedom of establishment. However, this will be outlined in section 8.2.5.

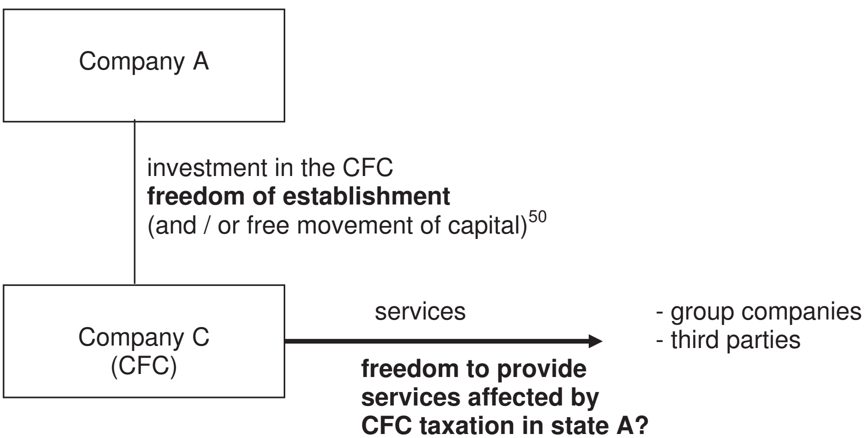
8.2.1.6. Conclusions Regarding CFC Legislation and the Freedom of Establishment

The case law of the ECJ shows that the requirements to come within the scope of the freedom of establishment are not very restrictive. What is required is the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period. What is further required in case of the secondary establishment in the form of a subsidiary company is that the shareholder has a definite influence on the company’s decisions which allows the shareholder to determine its activities. However, whether a definite influence exists or not must be seen, in my opinion, in the light of the commercial and company law of the respective Member State and can also be achieved on a factual or contractual basis. This does not necessarily require the majority shareholding of a single shareholder, but can also exist in case of substantial non-majority interests (e.g. in the *SGI* case a shareholding of 34 percent was sufficient to come within the scope of the freedom of establishment) and in cases in which minority shareholders have a common interest and combine their shareholdings in order to exercise the respective influence (e.g. in the *Columbus Container* case the respective shareholders had an interest of about 10 to 12.50 percent each). If these requirements are fulfilled, the shareholder can rely on the right of establishment. Thus, the investment in a CFC is, in principle, covered by Article 49 of the TFEU in the same way as any other secondary establishment. The critical aspect lies in the fact that the risk of tax avoidance is considered to be higher in case of passive and base company activities, i.e. the activities which are typically in the scope of CFC taxation, compared to active business activities which are provided to third parties. It is also clear, in my opinion, that the *mere* holding of assets, in whatever form, cannot be seen as an economic activity in the sense of Article 49 of the TFEU. In my opinion, a certain (minimum) economic output must be created in the host state. The separation from wholly artificial arrangements may therefore play an important role in case of CFC taxation. From the *Cadbury Schweppes* case it can be learned that an activity cannot be considered a wholly artificial arrangement if the subsidiary company is genuinely established in the host state and has the premises, staff and equipment necessary to carry out the services. It is not completely clear whether the further criteria outlined in the Opinion of the Advocate General play an additional role or not. The ECJ did not explicitly refer to these criteria. However, under the assumption that these (additional) criteria are equally important, it would be further required that the staff is competent to provide the services and that the decisions related to the services are actually taken by the responsible staff in the host Member State. This, however, would not require, in my opinion, that the subsidiary company cannot be directed from and controlled by the parent company or cannot be the recipient of services provided by the parent company, but from the overall picture it must be clear that the services are physically carried out by the subsidiary company in the host state and that the CFC is not a mere tool of execution. Based on the Opinion of the Advocate General, the services itself must have economic substance and cannot be (economically) “useless.” In an intra-group relationship, it would be necessary that the relocated services provide “added value” to the group. The latter criterion of an “added value” cannot be limited, in my opinion, to mere economic aspects, but should also encompass other important reasons which may compensate - from the perspective of the investor - for the economic disadvantages. In my opinion, the separation between investments which are “useful” and which create “added value” from those which are “useless” and which create “no added value” can be difficult. Due to the fact that the intention of saving taxes is not, as such, something which has to be considered abusive, I can hardly imagine that the ECJ will consider the latter element as a separate and isolated element in its examinations. For the question whether a genuine activity is carried out in the other Member State, the secondary establishment must be assessed in its totality. In my opinion, this is what the ECJ finally made in the *Cadbury Schweppes* decision. Furthermore, it is important to note that the ECJ case law with respect to direct and indirect taxation is not completely aligned. In my opinion, the conclusions from the VAT cases, like *Part Service*, do not change the settled case law with respect to the necessity of a ‘wholly artificial arrangement which does not carry out any genuine economic activity in the host state.’

8.2.2. CFC Legislation and the Freedom to Provide Services

In principle, the scope of the freedom of establishment and the freedom to provide services is different. The freedom of establishment requires the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period whereas the freedom to provide services requires the actual pursuit of an economic activity from either within the Member State of principal establishment to a recipient in another Member State or with a temporary link to the latter Member State. Without any doubt, the application of CFC rules generally requires the underlying income to be allocable to the company which carries on the activity in the host Member State. The investment in a CFC is therefore within the scope of the freedom of establishment if all of the required conditions are fulfilled, i.e. the shareholder has a definite influence on the company's decisions and the company pursues an economic activity through a fixed establishment in another Member State for an indefinite period. Hence, in the relationship between the Member State of principal establishment and the Member State of secondary establishment it is foremost Article 49 of the TFEU which is applicable - at least as long as it refers to the investment itself. However, it should not be overlooked that the CFC may provide services to (related and unrelated) non-resident recipients and even to the shareholder (parent company). These services might be negatively affected by the application of CFC rules.

Figure 1:



The investment of company A in Member State C is, in general, covered by the freedom of establishment as long as the participation confers definite influence on the company's decisions, and the services provided by the CFC are within the scope of the freedom to provide services. From the case law of the ECJ it is clear that

[50] The question whether the free movement of capital is affected strongly depends on the facts and circumstances. It was outlined earlier that - based on the jurisprudence of the ECJ - the freedom of establishment may prevail over the free movement of capital (with the result that the latter freedom cannot be relied on). I will come back to that aspect below where CFC legislation and the free movement of capital will be examined.

Article 56 of the TFEU confers rights not only on the provider of services but also on the recipient.[51] Thus, the question arises whether the recipient of the services (e.g. in country B) can rely on the freedom to provide services regarding possible restrictions caused by the CFC legislation of Member State A. Article 56 (1) of the TFEU stipulates that *"(…) restrictions on the freedom to provide services within the Union shall be prohibited in respect of nationals of Member States who are established in a Member State other than that of the person for whom the services are intended*." From *Säger / Dennemeyer* it is clear that *"(…) Article 59 of the Treaty requires not only the elimination of all discrimination against a person providing services on the ground of his nationality but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other Member States, when it is liable to prohibit or otherwise impede the activities of a provider of services established in another Member State where he lawfully provides similar services.*"[52] In principle, it seems that a restriction on the freedom to provide services may not only be caused by the Member State of the recipient of the services and the Member State of the service provider, but also by a "third" Member State (in this case Member State A).

In the *Cadbury Schweppes* case, Advocate General Léger had to deal with the submission of the applicant that the freedom to provide services might be affected. In his response, the Advocate General held that *"(t)hese proceedings concern the compatibility with Community law of legislation of a Member State which attributes to a resident parent company the profits of its subsidiary established in another Member State when that subsidiary is subject to a much lower level of taxation in that State. The nature of the activity carried on by CSTS and CSTI is not specifically referred to by that legislation. The situation is therefore different from that in the Safir and Eurowings Luftverkehr cases (…). Admittedly, if the legislation at issue has the result that a resident company is dissuaded from establishing a subsidiary in another Member State, it also has the result that the supply of services by such a subsidiary out of that Member State is prevented. However, the latter restriction is a consequence of the hindrance of establishment. In the present case, it is exactly the freedom to establish a subsidiary in that Member State which is at the core of the proceedings. I do not therefore see the relevance of reliance on the rules on freedom to provide services as well. In any event, I do not believe that examination of the legislation at issue in the light of that freedom, in addition to freedom of establishment, can change the result of my analysis."* [53] The ECJ did not go into much detail of this question in the *Cadbury Schweppes* decision. The Court merely stated that the restrictive effects on the free movement of services and the free movement of capital are an unavoidable consequence of any restriction on the freedom of establishment. Pursuant to the Court, this does not justify an independent examination of the first-mentioned two basic freedoms.[54]

The conclusions of the Advocate General and the ECJ are certainly true in the relationship of the Member States A and C in case the investment is covered by the freedom of establishment. It seems to be clear from the examinations in chapter 4 that, in such a situation, the freedom of establishment prevails over the freedom to

[51] See case C-294/97 (*Eurowings*), paragraph 34; cases 286/82 and 26/83 (*Luisi and Carbone*), paragraph 16.
[52] Case C-76/90 (*Manfred Säger v Dennemeyer & Co. Ltd.*), July 25, 1991, ECR 1991, page I-04221, paragraph 12.
[53] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 35, 36.
[54] Case C-196/04 (*Cadbury Schweppes*), paragraph 33.

provide services and the free movement of capital. However, from the perspective of the service recipient in state B the situation might be different. Here, the freedom of establishment is not directly affected. Moreover, the question can be raised whether - in the relationship between companies A and C - the freedom to provide services prevails over the free movement of capital - or vice versa - in those cases in which the freedom of establishment is not affected, e.g. in case company A merely holds a minority interest in company C which does not provide definite influence over the company's decisions. However, the question of priority is foremost a question of the *purpose* of the CFC legislation. In my opinion, the purpose of CFC legislation is the targeting of certain investments and the result of such investments and does not directly focus on the provision of services. For this reason, the investment in the CFC should - from the perspective of companies A and C - fall within the scope of the free movement of capital and not, simultaneously, within the freedom to provide services.[55] From the perspective of the recipient of the services in Member State B there is no direct link to the investment activity.[56] However, taking into account the outcome of the *Test Claimants in the Thin Cap Group Litigation* case (*Thin Cap GLO* case)[57] - which dealt with the UK thin cap rules in a number of different constellations, including loans granted by sister companies in Member States and non-member states - one can conclude that any restriction on the services provided towards a recipient in state B is an unavoidable consequence of a restriction on the freedom of establishment caused by the application of the CFC rules in state A.[58] If the freedom of establishment is not affected, because according to the purpose of the legislation the rules shall be applied to participations irrespective of whether a definite influence exists or not (and, in case of a Member State, there is actually no definite influence on the decisions of the respective participation), the conclusion should be that any restriction on the services provided towards a recipient in state B is an unavoidable consequence of a restriction on the free movement of capital. The reason is that CFC rules, as mentioned above, target certain investments and the income derived through the investments, but not the services provided by the participants.[59] If one follows the reasoning of the ECJ in the *Thin Cap GLO* case, an independent examination of the freedom to provide services would not be justified. Eventually, the freedom to provide services would be of no particular relevance in this context.

8.2.2.1. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

It seems that the freedom to provide services will most likely not be affected by the application of CFC rules. The reason is that CFC rules target certain investments but not the services provided by the CFC. For this reason, it seems that, based on the jurisprudence of the ECJ, the freedom of establishment shall prevail over the freedom to provide services. In those cases in which not the freedom of establishment but the free movement of capital will be applicable, it is the latter freedom which will prevail over the freedom to provide services. The question arises whether this conclusion will

[55] Under the assumption, of course, that the freedom of establishment is not affected.
[56] The freedom to provide services confers rights not only to the provider of the services but also to the recipient of the services - similar to the free movement of capital which also confers rights to the investor and the (legal) person in which the investment is made.
[57] Case C-524/04 (*Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*), March 13, 2007.
[58] See case C-524/04 (*Thin Cap GLO*), paragraphs 33, 34 and 101 with respect to the UK thin cap rules.
[59] See in this respect also case C-524/04 (*Thin Cap GLO*), paragraphs 33 and 101.

be different in case of an alternative legislation which focuses on the current taxation of the basic interest component. In my opinion, an alternative legislation will not lead to a different conclusion, because the basic interest taxation will still be linked to the investment in another company and the income derived by this company, but will not be concentrated on the services provided. In other words, the application of CFC rules and the application of an alternative system which focuses on the basic interest component will both be covered by the freedom of establishment and / or the free movement of capital, but not by the freedom to provide services.

8.2.2.2. Conclusions Regarding CFC Legislation and the Freedom to Provide Services

From the *Cadbury Schweppes* case it can be concluded that the restrictive effects on the freedom to provide services and the free movement of capital are an unavoidable consequence of any restriction on the freedom of establishment which is caused by the application of CFC rules. This is certainly true for an investment which confers definite influence on the decisions of the CFC. The question arises whether the freedom to provide services can play a role in situations in which the freedom of establishment is not affected. In my opinion, there are two situations which are of particular interest. The first is the situation in which the services are provided to a shareholder who does not have definite influence on the decisions of the CFC. In this case, the free movement of capital should be affected and not the freedom to provide services. The reason is that the purpose of the CFC legislation is the targeting of certain investments and the result of such investments and does not directly focus on the provision of services. Based on the conclusions derived from the jurisprudence of the ECJ which was outlined in chapter 4, there seems to be no room - in this case - for any simultaneous application of the freedom to provide services. The second is the situation in which the services are provided to a recipient in another Member State who does not have any investment in the CFC. Here, the recipient of the services in the other Member State might fall within the scope of the freedom to provide services. However, if one follows the position of the ECJ in the *Thin Cap GLO* case, one should come to the conclusion that in such a situation a restriction on the freedom to provide services is an unavoidable consequence of any restriction on the freedom of establishment and / or, depending on the circumstances, the free movement of capital.

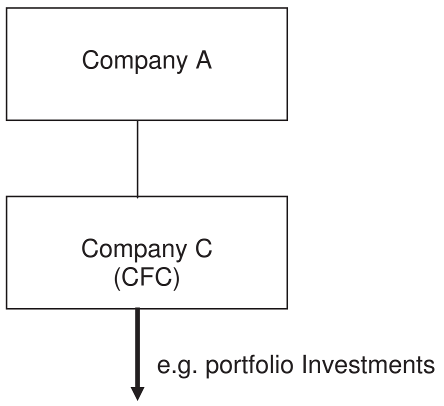
8.2.3. CFC Legislation and the Free Movement of Capital

Based on the earlier examinations, Article 63 of the TFEU does not only apply to direct investments which confer a definite influence on the company's decisions and allows the shareholder to determine the activities of the company, but is equally applicable to portfolio investments without any significant interest in the company. The scope of Article 63 of the TFEU is therefore much broader than the scope of Article 49 of the TFEU and encompasses minor investments in CFCs as well. It is important to note that according to the explanatory notes to the nomenclature,[60] direct investments have the meaning of investments of all kinds by natural persons or commercial, industrial or financial undertakings, and which serve to establish or to maintain lasting and direct links between the person providing the capital and the entrepreneur or the undertaking to which the capital is made available in order to

[60] See Annex I to Council Directive 88/361/EEC, June 24, 1988.

carry on an economic activity. Thus, the direct investment referred to in the nomenclature requires - in the same way as the freedom of establishment - the exercising of an economic activity. However, the non-exhaustive list contains - in addition to direct investments - a number of capital movements which do not require (and which are not connected to) an economic activity carried on in another Member State. In my opinion, the investment in a foreign company should therefore fall within the scope of the free movement of capital irrespective of the fact whether the foreign company carries on an economic activity or not. Of course, the absence of an economic activity may result in the conclusion that the investment is not to be considered a direct investment, but it would still be within the scope of the free movement of capital.

Figure 2:



Here, the investment in the CFC might theoretically be within the scope of the freedom of establishment and the free movement of capital. Based on the conclusions in chapter 4, the freedom of establishment is only examined if the purpose of the national legislation is the application to investments which confer a definite influence over a company's decisions. In contrast thereto, if the purpose of the legislation is the general application to portfolio and entrepreneurial investments, the freedom of establishment prevails over the free movement of capital if the *actual* investment confers definite influence over a company's decisions *and* the purpose of the legislation is linked to the objective of exercising the freedom of establishment. This is not the case if the 'free movement of capital aspect' of the national legislation is the decisive element.[61] It is apparent, in my opinion, that the latter is not the case in CFC type legislations - which focus on the taxation of income realised by the legal entity in the other state. CFC rules, even if applied in case of minor holdings, are directly linked to the activity carried out in the other state and not just linked, for example, to a specific share transaction or restructuring element.[62] Therefore, also in case of a broader CFC type legislation the ECJ should start examining Article 49 of the TFEU if the actual investment confers definite influence. I will come to that point in the following.

[61] See with respect to the 'free movement of capital aspect' case C-182/08 (*Glaxo Wellcome*), paragraph 50.
[62] As was the case in the *Glaxo Wellcome* decision.

Thus, if the purpose of the CFC legislation is the application to investments which confer a definite influence on the company's decisions, it is the freedom of establishment which is to be examined exclusively. This, of course, can have the important consequence that the taxpayer cannot rely on the freedom of establishment, e.g. in case of an investment in a CFC in a non-member state, but cannot rely on the free movement of capital either, because the latter freedom will not be subject to examination - due to the fact that the purpose of the national legislation is the application to investments which confer definite influence on the company's decisions.

In my opinion, if the ECJ consistently applies the principles which were outlined in chapter 4 with respect to the "competition" among the basic freedoms, this can have a major impact on CFC investments in non-member states. The reason is that the CFC rules could be understood - at least with respect to the general application and a substantial part of the scope of such legislation - to focus on investments which confer a definite influence on the CFC situated in the other state. Even though it is clear from chapter 6 that the requirement of a majority shareholding is rather an exception, often some sort of controlling participation is still required for the general application of these rules. In any event, the structure of CFC legislation can be similar to the thin-cap legislation which was subject to verification in the *Lasertec* decision. In the latter case, the thin-cap legislation was (also) applicable to a participation of not more than 25 percent if the participation - independent from or in collaboration with other shareholders - conferred *controlling influence*. [63] Thus, if the purpose of the respective CFC legislation is the application to shareholdings which confer a definite influence over the decisions of the CFC, this will close the door for Article 63 of the TFEU in case of non-member states.

On the other hand, the CFC rules are sometimes also applicable to certain types of passive income without requiring any minimum participation (e.g. in case of FIF type rules). Following the principles outlined in chapter 4, the ECJ should, in the latter situation, first examine the freedom of establishment if the actual participation confers definite influence over the company's decisions. The reason is that, as outlined above, the 'free movement of capital aspect' does not prevail in case of CFC rules. However, if it turns out that Article 49 of the TFEU is not affected - because of an investment in a non-member state - the ECJ should, in a second step, examine the application of Article 63 of the TFEU. Hence, the structure of the respective CFC legislation can have an influence on the question whether Article 63 of the TFEU may be affected or not. From my perspective, the ECJ should examine in detail the national measure in the underlying case. If, for example, certain types of passive income are subject to CFC taxation irrespective of the percentage of shareholding and irrespective of any influence on the company, as in case of Germany for certain types of income, it should not matter whether the general CFC concept - with respect to other types of income - requires a controlling influence. It would be logical to "separate" the CFC legislation in such a case. This, of course, can have the consequence that Article 63 of the TFEU can be affected in one situation but not in another (even though it is related, in broader terms, to one and the same CFC concept of a single Member State).

[63] Case C-492/04 (*Lasertec*), paragraph 4.

I have to confess, though, that the answer to the question whether Article 63 of the TFEU is applicable in case the parent company exercises definite influence over a non-member state CFC, but where the national legislation does *not* require definite influence, is not completely clear. At least, some uncertainty was created by the decision in *SGI*, where the ECJ concluded that, in the respective situation, it was necessary to answer the questions referred solely in the light of the freedom of establishment.[64] However, it is important to note that the situation in *SGI* was not related to investments in non-member states. Moreover, previous decisions like *Holböck* and *Test Claimants in the FII Group Litigation* rather suggest, in my opinion, that Article 63 of the TFEU should still be applicable.[65] Currently, some uncertainty remains, but the ECJ has the possibility to answer exactly this question in the pending case C-35/11, which is "part two" of the aforementioned *Test Claimants in the FII Group Litigation* case.[66]

8.2.3.1. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

It seems to be obvious from the examination outlined above that the investment in the CFC falls within the scope of the free movement of capital - if there is no prevailing freedom which has to be examined first and which "closes the door" for the application of Article 63 of the TFEU. Thus, if the investment in the CFC is within the scope of the latter freedom, this should have consequences not only for the application of the "typical" CFC regimes according to chapter 6, but also for the application of any other system which focuses on a current taxation of income. In other words, an alternative system which focuses on the current taxation of the basic interest component can be within the scope of the free movement of capital under the circumstances described above. Of course, in the latter case it remains the question whether the application of the alternative system results in an (unjustified) restriction on the free movement of capital. This will be outlined in section 8.2.5.

8.2.3.2. Conclusions Regarding CFC Legislation and the Free Movement of Capital

The scope of the free movement of capital is much broader than the scope of the freedom of establishment. Article 63 of the TFEU not only encompasses shareholdings with definite influence over the company's decisions, but also encompasses minority investments in foreign companies and other types of portfolio investments. Furthermore, the free movement of capital does not require the pursuit of an economic activity. In general, the investment in a CFC which does not provide definite influence over the company's decisions is within the scope of the free movement of capital. However, the principles derived from the case law of the ECJ

[64] Case C-311/08 (*SGI*), paragraph 37.
[65] Case C-157/05 (*Holböck*), paragraphs 28-31 and case C-446/04 (*Test Claimants in the FII Group Lititgation*), paragraph 165.
[66] See with respect to the pending case C-35/11 also Philip Baker, UK: Forthcoming UK Case: *FII GLO* (Part 2), in Lang, Michael / Pistone, Pasquale / Schuch, Josef / Staringer, Claus / Storck, Alfred (eds.), ECJ - Recent Developments in Direct Taxation 2010, Series on International Tax Law, 2011, page 223 et seq. One of the questions referred to the ECJ in case C-35/11is the following: "*where the national legislation in question does not apply exclusively to situations in which the parent company exercises decisive influence over the dividend paying company, can a resident company rely upon Article 63 TFEU (formerly Article 56 EC) in respect of dividends received from a subsidiary over which it exercises decisive influence and which is resident in a third country?*"

with respect to the “competition” among the basic freedoms show that in some situations the taxpayer may not be able to rely on the free movement of capital since the prevailing application of the freedom of establishment results in an exclusive examination of the latter freedom. At least, this is the case if the purpose of the national legislation is the application to investments which confer definite influence over the company’s decisions. Of course, this can be important in case of investments in non-member states where Article 49 of the TFEU is not affected and Article 63 of the TFEU will not be examined because of the fact that Article 49 of the TFEU (theoretically) prevails. However, it should be also clear, in my opinion, that the national legislation must be examined carefully in a CFC case and that the purpose of the legislation is not necessarily the same for the whole CFC concept. For example, the CFC rules can, in general, require definite influence over the company’s decisions but can also be applicable - e.g. with respect to certain types of income - irrespective of the percentage of shareholding and irrespective of any influence on the company (e.g. in case of FIF type rules). Here, it depends on the facts and circumstances in the underlying case and the exact provisions of the national legislation whether the door for the application of Article 63 of the TFEU is open or not. However, the existing case law of the ECJ leaves some uncertainty with respect to the application of Article 63 of the TFEU in a situation in which the parent company exercises definite influence over a non-member state CFC, but where the national legislation does *not* require definite influence. In general, the following differentiation can be made:

A. (Part of) CFC legislation which requires definite influence over the decisions of the CFC	the following basic freedoms are affected:
a.) CFC in another Member State	Article 49 TFEU
b.) CFC in a non-member state	---
B. (Part of) CFC legislation which does not require definite influence over the decisions of the CFC (e.g. FIF type legislation)	the following basic freedoms are affected:
a.) CFC in another Member State	
aa.) definite influence (actually)	Article 49 TFEU
ab.) no definite influence (actually)	Article 63 TFEU
b.) CFC in a non-member state	
ba.) definite influence (actually)	Article 63 TFEU (uncertain)
bb.) no definite influence (actually)	Article 63 TFEU

The differentiation is, of course, based on the above conclusion that the 'free movement of capital aspect' does not prevail in case of CFC type legislation. Overall, it is important to note that the CFC legislation as well as any alternative legislation which requires definite influence on the decisions of the CFC apparently does not - based on the jurisprudence of the ECJ - fall within the scope of the free movement of capital.

8.2.4. Additional Examinations

8.2.4.1. Restrictions Caused by the Application of CFC Legislation

Based on the case law of the ECJ, any restriction on the basic freedoms is prohibited, even if it is of limited scope or minor importance.[67] The application of CFC rules has the effect that income (or a specific part of the income) which is realised through the foreign company is immediately attributed to the domestic shareholder and included in the domestic tax base. In effect, there is no possibility to shelter the income from domestic taxation - which is normally the case if the income is derived by a separate legal entity - and has therefore, at least, a negative effect from a liquidity perspective.[68] It was already outlined in chapter 6 that the current taxation of CFC income may cause massive disadvantages compared to a purely domestic situation, e.g. in case of multiple tier structures, in cases where the domestic taxpayer is unable to credit the foreign income tax against the domestic income tax (for example in case of a domestic tax loss carry forward), and in similar situations. However, even in a "best case scenario" of an unrestricted ordinary tax credit, it will always lead to the result that the tax burden related to the CFC income is increased from the lower level of the country of secondary establishment to the higher level of the country of primary establishment. The domestic shareholder has to pay an additional tax on income which is legally derived by another person (legal entity) and which is therefore, in principle, outside of the availability of the domestic taxpayer. The domestic taxpayer either has to use his own funds[69] to pay the additional income tax - which will then have a negative effect on the liquidity of the shareholder - or has to start the process of transferring the financial means from the CFC to the domestic shareholder, e.g. through a profit distribution. Even if one leaves aside the rather difficult situations in which other shareholders are involved, in which only a minority shareholding exists in the CFC, or situations in which the legal income of the CFC deviates considerably from the income determined according to the CFC rules, it will in any event require additional legal steps to make available (part of) the income which was subject to domestic taxation for the payment of the additional

[67] Case C-49/89 (*Corsica Ferries France*), ECR 1989 page 4441, paragraph 8; case C-34/98 (*Commission of the European Community v French Republic*), February 15, 2000, ECR 2000, page I-00995, paragraph 49: *"(t)he free movement of goods, persons, services and capital are fundamental Community provisions and any restriction, even minor, of that freedom is prohibited;"* Case C-9/02 (*Hughes de Lasteyrie du Saillaint v Ministere de l'Economie, des Finances et de l'Industrie*), March 11, 2004, ECR 2004, paragraph 43: *"...a restriction on freedom of establishment is prohibited by Article 52 of the Treaty even if of limited scope or minor importance*;" Case C-483/99 (*Commission of the European Communities v French Republic*), June 4, 2002, ECR 2002 page I-04781, paragraph 21: *"Those national rules, although applicable without distinction, create obstacles to the right of establishment of nationals of other Member States and to the free movement of capital within the Community, inasmuch as they are liable to impede, or render less attractive, the exercise of those freedoms."*

[68] This will be the case if the attribution of income causes additional income tax payments of the shareholder.

[69] Which also includes the re-financing of these funds, e.g. through a bank loan.

income tax. Thus, in a "best case scenario" of a 100 percent shareholding in the CFC, an income attribution which is more or less equal to the legal result of the CFC, and an "optimal" ordinary tax credit, the disadvantage may be - at first glance - limited to the liquidity effect related to the additional tax burden and the administrative obligations which are related to the transfer of the financial means from the CFC to the domestic shareholder. However, an additional burden which is caused by the investment in a CFC are the compliance costs. The domestic taxpayer can be required to provide additional tax returns and calculations in order to determine the CFC income.[70] The preparation of additional documents not only increases the total compliance costs but may also increase the tax risk of the domestic shareholder. Overall, it can be concluded that even in an optimal scenario the CFC income attribution still has negative consequences for the domestic shareholder. In a non-optimal scenario, the CFC taxation may result in a double taxation of income. Of course, it is out of the question that an effect such as the double taxation of income caused by the mechanism of CFC taxation is a substantial restriction on the exercising of the basic freedoms. However, even negative effects of "minor importance," like liquidity disadvantages and additional administrative burdens, are sufficient, in my opinion, to create an obstacle for the exercising of the right of establishment, the free movement of capital, and the freedom to provide services. In this context, the *Safir* case can be referred to where administrative obligations and liquidity disadvantages were put forward as arguments for a restriction caused by the legislation of the Member State in question. With respect to administrative obligations the Court pointed out that *"(i)t is true that such obligations cannot in themselves be regarded as being contrary to Community law. However, those obligations, combined with the need to follow a centralised procedure, may dissuade interested persons from taking out capital life assurance companies not established in Sweden, since no particular action on their part would be called for if they took out such assurance with companies established in Sweden, the tax being levied in this case on the company."*[71] Moreover, from a number of other cases it can be learned that a measure which leads to a cash-flow disadvantage can have a restrictive effect on the exercising of the basic freedoms.[72]

A decision which may be helpful to support the conclusion that the application of CFC rules may have a restrictive effect is *de Lasteyrie du Saillant*: the case deals with French legislation concerning tax charged on an unrealised increase in the value of securities, which is due in the event of a taxpayer transferring his residence outside France for tax purposes.[73] The increase in value to be determined shall be the difference between the value of the company securities at the date of transfer of residence outside France for tax purposes and the price at which they were acquired

[70] The fact that in most cases the CFC income has to be determined according to the domestic rules and not according to the rules of the state of residence of the CFC requires an additional computation which is solely made for the purpose of CFC income attribution. This, of course, leads to additional obligations for the shareholder in the CFC (see in this respect 6.6. of this study and Arnold / Dibout, General Report, in Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, IFA 2001, page 58). This can result in the submission of separate tax returns in order to assess the attributable income (see in this respect, for example, paragraph 18 of the German Foreign Income Tax Act).
[71] Case C-118/96 (*Safir*), paragraph 26; see in more detail chapter 4.
[72] Case C-397/98 and C-410/98 (*Metallgesellschaft and Others*), paragraphs 44, 54 and 76; case C-436/00 (*X and Y*), paragraphs 36 to 38; case C-268/03 (*De Baeck*), paragraph 24; case C-446/03 (*Marks & Spencer*), paragraphs 32 to 34; case C-446/04 (*Test Claimants in the FII Group Litigation*), paragraphs 96, 97, 153 and 154; case C-347/04 (*Rewe Zentralfinanz*), paragraph 29.
[73] Case C-9/02 (*de Lasteyrie du Saillaint*), paragraph 2.

by the taxpayer.[74] Payment of the tax on the increase in value determined may be deferred until the time of the transmission, redemption, repayment or cancellation of the company securities concerned. However, the suspension of payment is subject to the condition that the taxpayer shall declare the amount of increase in value, applies for the benefit of suspension, designates a representative established in France authorised to receive communications concerning the basis of assessment, collection of the tax and any disputes relating thereto, and, before his departure abroad, constitutes with the official responsible for collection guarantees sufficient to ensure recovery of the debt by the Treasury. At the expiry of five years from the date of departure, or at the date on which the taxpayer retransfers his place of residence to France for tax purposes, if earlier, exoneration shall be automatically granted in so far as it relates to increases in value in relation to company securities which, at that date, remain in the ownership of the taxpayer.[75] The guarantees may take the form of a cash payment into a Treasury suspense account, an acknowledgement of indebtedness in favour of the Treasury, the lodging of a deposit, securities, goods deposited at State-approved warehouses and subject to warrant endorsed in favour of the Treasury, by mortgage charges, by pledging of business assets.[76] In its decision, the ECJ made it clear that a restriction on freedom of establishment is prohibited *"(…) even if of limited scope and minor importance."*[77] And even if the respective legislation *"(…) does not prevent a French taxpayer from exercising his right of establishment, this provision is nevertheless of such a kind as to restrict the exercise of that right, having at the very least a dissuasive effect on taxpayers wishing to establish themselves in another Member State. A taxpayer wishing to transfer his tax residence outside French territory, in exercise of the right guaranteed to him by Article 52 of the Treaty, is subjected to disadvantageous treatment in comparison with a person who maintains his residence in France. That taxpayer becomes liable, simply by reason of such a transfer, to tax on income which has not yet been realised and which he therefore does not have, whereas, if he remained in France, increases in value would become taxable only when, and to the extent that, they were actually realised. That difference in treatment concerning the taxation of increases in value, which is capable of having considerable repercussions on the assets of a taxpayer wishing to transfer his tax residence outside France, is likely to discourage a taxpayer from carrying out such a transfer."*[78]

A comparison of the French legislation in the *de Lasteyrie du Saillant* case with the taxation according to CFC legislation shows, in my opinion, that the latter goes even further than the French legislation in question, i.e. CFC legislation usually has an effect which is more restrictive. The following aspects have to be taken into account:

- The French legislation focuses on the increase in value of the shares at the moment when the taxpayer transfers his residence to another country. It is the accumulated profit, plus unrealised reserves and goodwill, which is, in essence, taken into account. In contrast thereto, the CFC legislation focuses on the taxation of the profit on a regular - yearly - basis. Thus, an important

[74] The taxation of the increase in value thus realised is subject to the condition that the rights in company profits held directly or indirectly by the transferor or the transferor's spouse, their ascendants and descendants, must together exceed 25 percent of those company profits held at some time during the previous five years (see case C-9/02 (*de Lasteyrie du Saillaint*), paragraph 4).
[75] Case C-9/02 (*de Lasteyrie du Saillaint*), paragraph 3.
[76] Case C-9/02 (*de Lasteyrie du Saillaint*), paragraph 4.
[77] Case C-9/02 (*de Lasteyrie du Saillaint*), paragraph 43.
[78] Case C-9/02 (*de Lasteyrie du Saillaint*), paragraphs 45, 46.

difference lies in the fact that certain components which make up the value of shares are not taken into account on a yearly basis - under CFC rules - but only over a longer period of time. This might lead to the conclusion that the (theoretical) tax base pursuant to the French legislation at the moment of transfer is higher than the total number of income attributions pursuant to CFC rules at the same point in time. However, this is solely a timing difference: the CFC rules will finally also encompass those profits which are not realised on a regular basis but which are inherent in the assets of the company and the activity itself (e.g. goodwill).

- The most significant difference lies in the fact that the French legislation in question provides the possibility for a suspension of the tax payment until the time of the transmission, redemption, repayment or cancellation of the company securities. This opens the possibility to pay the tax out of the proceeds derived from the actual sale of the shares (or similar transactions). Furthermore, if the shares are retransferred to France or sold after the expiration of five years, there will be no taxation of the increase in value of the shares. In general, there is no such possibility in case of CFC legislation. Here, the income is attributed to the domestic shareholder and consequently taxed on a regular basis. It does not play a role whether the income of the foreign company is available for the payment of the taxes or not and there is, in principle, no possibility for a suspension of the tax payment on the attributed income.

- Obviously, the conditions related to the suspension of the tax payment constitute a restrictive effect. However, the French legislation provides, at least, different possibilities to avoid the actual tax payment. This is not the case for the taxes imposed through CFC rules. The extensive administrative obligations exist in case of the French legislation in question and in case of CFC regimes, and I do not think that the requirements are less restrictive in the latter case (taking into account that the additional tax returns etc. have to be submitted on a yearly basis).

In my opinion, the statement of the ECJ can be easily transferred to CFC legislation: *“(a) taxpayer wishing to transfer his tax residence outside French territory* (in case of CFC legislation: wishing to invest outside the (…) territory), *in exercise of the right guaranteed to him by Article 52 of the Treaty, is subjected to disadvantageous treatment in comparison to a person who maintains his residence in France* (in case of CFC legislation: invests in the (…) territory). *That taxpayer becomes liable (…) to tax on income which has not yet been realised and which he therefore does not have, whereas, if he remained in France* (in case of CFC legislation: if he invests in (…) territory)*, increases in value* (in case of CFC legislation the profits of the foreign company in the other Member State might be referred to) *would become taxable only when, and to the extent that, they were actually realised. That difference in treatment (…) is likely to discourage a taxpayer from carrying out such a transfer* (in case of CFC legislation: making such an investment).”[79] It can certainly be concluded that - from the perspective of the domestic investor - the application of CFC legislation makes the investment in another Member State less attractive. It results in an immediate taxation of income and an overall increase in the income tax burden.

[79] See in this respect case C-9/02 (*de Lasteyrie du Saillaint*), paragraph 46.

Moreover, the foreign investment creates additional administrative obligations in the Member State of principal establishment which would not exist in case of a purely domestic investment.[80]

The restrictive effect becomes particularly obvious if the perspective of the Member State of the CFC, i.e. the Member State of secondary establishment, is taken into account, too. In the *Verkooijen* decision the ECJ concluded that the Dutch provision in question *"(...) has a restrictive effect as regards companies established in other Member States: it constitutes an obstacle to the raising of capital in the Netherlands since the dividends which such companies pay to Netherlands residents receive less favourable tax treatment than dividends distributed by a company established in the Netherlands, so that their shares are less attractive to investors residing in the Netherlands than shares in companies which have their seat in that Member State."*[81] The investment in a foreign company which is classified as a CFC is definitely less attractive for investors resident in the country which applies the CFC regime. These investors might refrain from investing in the CFC country and decide to invest in the Member State of principal establishment or might decide to invest in another country which is outside of the scope of the domestic CFC regime (e.g. because the tax rate is above the domestic threshold of low-taxation). Such legislation therefore constitutes - similar to the Dutch legislation in the *Verkooijen* case - an obstacle to the raising of capital in the Member State which applies the CFC rules. The Member State of secondary establishment therefore has a competitive disadvantage not only compared to the Member State of principal establishment but also to the other Member States and even third countries which are not affected by the relevant legislation. One should always keep in mind that CFC legislation mainly focuses on income taxation. It will therefore specifically affect those countries with a reduced income tax rate (compared to the Member State which applies the CFC legislation). However, those countries are not necessarily to be classified as "tax havens." Those countries may simply have a relatively low corporate income tax rate but a comparably high personnel income tax rate or value added tax rate. These "investor friendly regimes" - applied to residents and non-residents - are far from being a "tax haven." In my opinion, it is quite obvious that from the perspective of the latter Member States the CFC legislation may create a serious obstacle for the attraction of capital investments.

The outcome of the *Cadbury Schweppes* case - the first decision of the ECJ which dealt with CFC legislation - is therefore not surprising to me with respect to the question whether a restriction on the freedom of establishment exists or not. The Court concluded that the *"(...) difference in treatment creates a tax disadvantage for the resident company to which the legislation on CFCs is applicable. Even taking into account (...) the fact referred to by the national court that such a resident company does not pay, on the profits of a CFC within the scope of application of that legislation, more tax than that which would have been payable on those profits if they had been made by a subsidiary established in the United Kingdom, the fact remains that under such legislation the resident company is taxed on profits of another legal person. That is not the case for a resident company with a subsidiary taxed in the United Kingdom or a subsidiary established outside that Member State which is not*

[80] In addition to the administrative obligations in the CFC country itself and the overall risks related to a foreign investment in general.
[81] Case C-35/98 (*Verkooijen*), paragraph 35.

subject to a lower level of taxation."[82] And *"(t)he resulting disadvantage for resident companies (...) are such as to hinder the exercise of freedom of establishment by such companies, dissuading them from establishing, acquiring or maintaining a subsidiary in a Member State in which the latter is subject to such a level of taxation. They therefore constitute a restriction on freedom of establishment (...)."* [83] The decision confirms, in principle, the conclusions which can already be drawn from the previous case law outlined above.

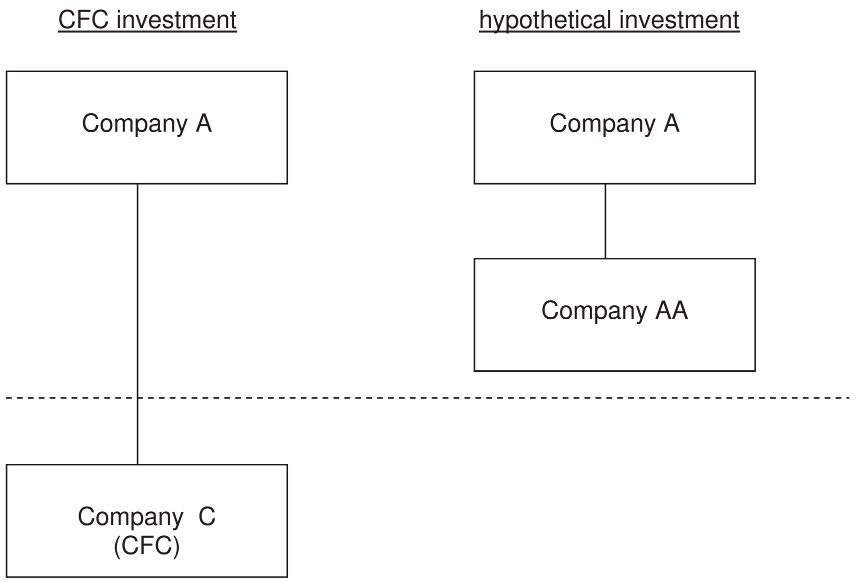
Overall, the application of CFC rules has, in my opinion, a restrictive effect on the exercising of the right of establishment and the free movement of capital, respectively. Whether it also has a restrictive effect on the freedom to provide services from the perspective of the recipient of the services provided by the CFC, i.e. an indirect effect, depends on the respective legislation. For example, if the CFC legislation (of Member State A) is structured in a way that the provision of services to recipients in the country of residence of the CFC (country C) is outside of the scope of the CFC legislation, but the provision of services to recipients in other Member States (e.g. Member State B) is affected, a situation may be created which is disadvantageous for the recipient in Member State B (just due to the fact that the recipient is not resident in Member State C but in Member State B). The provision of services from within Member State C to Member State B is less attractive and may therefore not be offered to the conditions which are available for services provided solely within Member State C.[84] The recipients in country B may therefore be forced to pay more for the services rendered than the recipients in country C - just because of the application of the CFC rules of country A. It may also be the case that the services are not fully available for recipients in country B. This can be the case if the CFC legislation follows an entity approach where it is decisive that the income of the CFC is mainly derived from activities in the country of residence (and / or certain active businesses). Overall, it can be concluded that the CFC legislation may also have a restrictive effect for the recipient of the services who is established in another Member State.

8.2.4.2. The Pair of Comparison - Vertical and Horizontal Comparison?

The most obvious pair of comparison in order to find out whether the cross-border investment in a CFC is subject to a different - restrictive - treatment in the Member State of primary establishment is certainly the direct comparison with a merely domestic investment. Thus, the comparison can be made between the tax treatment of a domestic taxpayer with a foreign subsidiary established in a country which triggers the CFC taxation and a domestic taxpayer with a hypothetical domestic subsidiary (vertical comparison).

[82] Case C-196/04 (*Cadbury Schweppes*), paragraph 45.
[83] Case C-196/04 (*Cadbury Schweppes*), paragraph 46.
[84] However, this requires that the situation in Member State A is taken into account, too. The reason is that the tax burden in Member State C is the same for services provided to residents and non-residents.

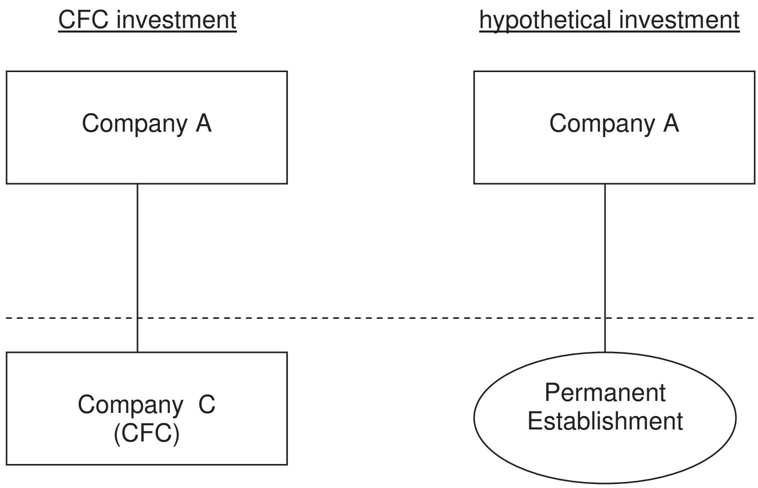
Figure 3:



The question arises whether it is possible to extend the comparison to foreign permanent establishments. This might be a comparison between a domestic taxpayer with a foreign subsidiary in a country which triggers the CFC taxation and a domestic taxpayer with a hypothetical foreign permanent establishment (horizontal comparison).[85] In a purely domestic situation the income of the (domestic) permanent establishment is usually included in the income tax base of the (domestic) taxpayer, e.g. head-quarter company. In contrast, the income of the domestic subsidiary is, in principle, treated separately from the income of the parent company as long as no fiscal consolidation (or fiscal unity) exists between the two companies. Thus, there may even be a choice for the domestic parent company to consolidate the taxable income or to treat the taxable income of both entities completely separate. However, in a cross-border situation, it may be the case that the income of the foreign permanent establishment is exempt from domestic taxation (if the exemption method is applied), but the income of the foreign company is subject to CFC taxation. From the perspective of a domestic (parent) company - which is in the focus of the comparison - the foreign investment through a subsidiary company and a foreign investment through a permanent establishment are treated differently.

[85] See Cordewener / Dahlberg / Pistone / Reimer / Romano, The Tax Treatment of Foreign Losses: *Ritter, M & S*, and the Way Ahead (Part Two), European Taxation 2004, page 218 et seq. (230).

Figure 4:



It is apparent from the earlier examinations that the current taxation of low-taxed income can be a disadvantage for the domestic taxpayer. The difference in the legal form (separate legal entity vs. branch) is, in principle, not an obstacle for the creation of such a pair of comparison. However, in contrast to the comparison between a foreign investment in a CFC and a domestic investment in a (hypothetical) subsidiary, the restrictive treatment of the investment in a CFC - in comparison to the investment in a foreign permanent establishment - is not caused by the cross-border investment as such.[86] It is the state of the parent company which treats the investment in a foreign permanent establishment different from the investment in a foreign CFC. In this particular case, the income of the permanent establishment is exempt from domestic taxation, which may be an advantage if it relates to income which is taxed at a lower rate than in the state of primary establishment. However, at first glance the obligation of the state of primary establishment to provide for an equal treatment of the different forms of secondary establishment cannot be derived from the basic freedoms.[87] The different treatment of an outbound investment by the Member State of primary establishment must not be mixed up with a different treatment of an inbound investment by the Member State of secondary establishment. In the latter case it is quite clear that the different treatment of resident and non-resident taxpayers requires a justification in order to be accepted under the basic freedoms.[88] The *Marks & Spencer* case could have been of particular relevance with respect to the question whether a horizontal comparison is acceptable or not.[89] Here, the United Kingdom group relief prevents resident parent companies from reducing its taxable

[86] See with respect to the *Marks & Spencer* case: Cordewener / Dahlberg / Pistone / Reimer / Romano, The Tax Treatment of Foreign Losses: *Ritter, M & S*, and the Way Ahead (Part Two), European Taxation 2004, page 218 et seq. (231).
[87] Cordewener, Europäische Grundfreiheiten und nationales Steuerrecht, page 831 et seq.
[88] See in this respect case C-307/97 (*Saint Gobain*); Cordewener / Dahlberg / Pistone / Reimer / Romano, The Tax Treatment of Foreign Losses: *Ritter, M & S*, and the Way Ahead (Part Two), European Taxation 2004, page 218 et seq. (232).
[89] Case C-446/03 (*Marks & Spencer*).

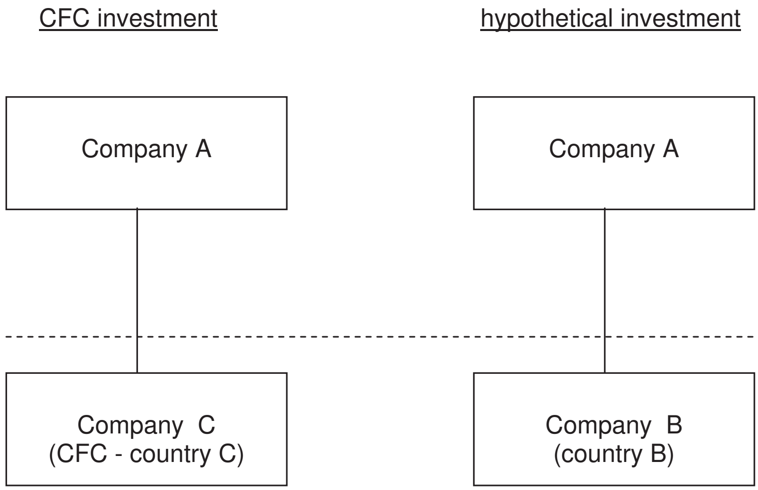
profits in the United Kingdom by setting off losses incurred in other Member States by non-resident subsidiary companies. In contrast thereto, the losses of foreign permanent establishments can be taken into account for the determination of the domestic tax base. This difference in treatment was referred to in the questions submitted by the High Court of Justice of England and Wales for a preliminary ruling.[90] However, the ECJ concentrated its verification on a vertical comparison between resident and non-resident subsidiaries and made only a brief statement which made it clear that the analysis will not be affected by the indications set out in the second part of the first question (which also included the difference in treatment related to a permanent establishment).[91] Hence, the difference in treatment between a foreign permanent establishment and a foreign subsidiary was, at least indirectly, addressed and accepted.

From the *Columbus Container* decision - which is outlined in chapter 4 - it can be understood, in my opinion, that the Member State of primary establishment is solely obliged to ensure that *comparable* investments are treated equally. In the case itself, it was argued that the application of the national legislation in question leads to a distortion of the choice between the different types of establishments (in this case subsidiary vs. partnership).[92] In its answer to this argument the Court stated that *"(…) it must be recalled that the fiscal autonomy (…) also means that the Member States are at liberty to determine the conditions and the level of taxation for different types of establishments chosen by national companies or partnerships operating abroad, on condition that those companies or partnerships are not treated in a manner that is discriminatory in comparison with comparable national establishments*."[93] This was subsequently confirmed in the *X Holding* case, where the Court made it clear that *"(…) the Member State of origin is not obliged to apply the same tax scheme to non-resident subsidiaries as that which it applies to foreign permanent establishments*."[94] In other words, the comparison should be limited to a vertical comparison and cannot be extended to a horizontal comparison between two different forms of establishment.[95]

An additional question which can be raised is the question whether the comparison can be extended to a hypothetical subsidiary company in another Member State, i.e. whether a comparison can be made between the tax treatment of a domestic taxpayer with a foreign subsidiary established in a CFC country and a domestic taxpayer with a hypothetical foreign subsidiary in a country where the CFC rules are not applicable.

[90] Case C-446/03 (*Marks & Spencer*), paragraph 26.
[91] Case C-446/03 (*Marks & Spencer*), paragraph 52.
[92] Case C-298/05 (*Columbus Container*), paragraph 52.
[93] Case C-298/05 (*Columbus Container*), paragraph 53.
[94] Case C-337/08 (*X Holding*), paragraph 40.
[95] See in this respect also Thömmes, Übergang zur Hinzurechnungsmethode bei Betriebsstätten EG-rechtskonform, Internationale Wirtschafts-Briefe 2008, page 1169 et seq. (1173).

Figure 5:



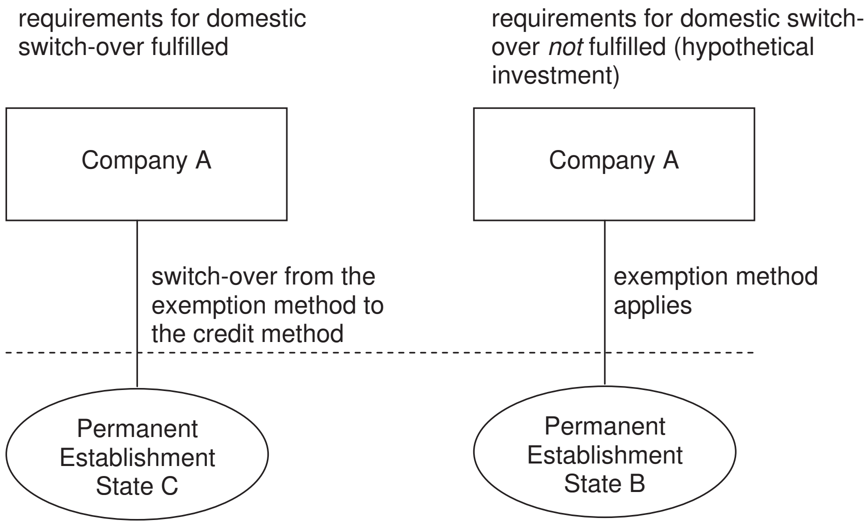
In contrast to the horizontal comparison between a foreign subsidiary company and a foreign permanent establishment, it is the same (legal) form of secondary establishment which is compared. The comparison is, in substance, not different from the comparison with a hypothetical resident subsidiary. The reason is that the hypothetical resident subsidiary and the hypothetical non-resident subsidiary in a state where the CFC rules are not applicable are treated identically, at least as far as it relates to the question whether the income of the separate legal entity is to be attributed on a current basis to the resident shareholder or not. It shows, however, that the advantageous treatment of domestic investments is also granted to foreign investments if the CFC rules cannot be applied. This can make the restrictive effect of CFC rules even more visible. It opens the possibility to take advantage of lower tax rates in some states (which are above the domestic threshold for the application of CFC rules) but not in others (where the CFC rules apply). From the perspective of competition among Member States, the CFC state itself not only suffers a disadvantage in the direct relationship to the Member State which applies the CFC regime, but also in comparison to other states which are outside of the scope of the relevant regime. In the *Cadbury Schweppes* case, Advocate General Léger outlined that *"(t)he legislation at issue provides that the profits of the controlled subsidiary may be included in the tax base of the parent company as they arise. It is therefore disadvantageous to the parent company to which it applies compared to, on the one hand, a resident company which has established its subsidiary in the United Kingdom and, on the other, a resident company which has established such a subsidiary in a Member State which does not have a sufficiently favourable regime to fall within its scope of application. In the first case, the resident company is never taxed on the profits of its domestic subsidiary. In the second case, the resident company is not taxed on the profits of its foreign subsidiary as they arise. It cannot be taxed until* *those profits are paid to it in the form of dividends.*"[96] At first glance - and having in mind the statement of the Advocate General - one can have the impression that, in its decision, the ECJ considered the existence of the two possibilities of comparison as well, i.e. the vertical comparison and the horizontal comparison of the same form of establishment. At least, in paragraphs 44 and 45 of the judgment the ECJ made 'comparisons' where reference was made to "*the United Kingdom or in a State in which it is not subject to a lower level of taxation*" and "*the United Kingdom or a subsidiary established outside that Member State which is not subject to a lower level of taxation*", respectively.[97] The problem is, however, that it is not clear enough from the *Cadbury Schweppes* decision whether the ECJ really referred to the (additional) horizontal comparison of the same form of establishment or whether the statement in paragraphs 44 and 45 of the decision was just made without the intention of explicitly referring to the existence of such a possibility. Finally there was no need for a horizontal comparison since the vertical comparison was already sufficient to identify a different treatment. In international tax literature there are different positions with respect to the question whether the ECJ accepted the horizontal comparability. For example, Calderón and Baez concluded that the admission of horizontal comparability is not explicit or, at least, not as explicit as that contained in the Opinion of the Advocate General. However, there is - in contrast to previous cases - the recognition of horizontal pairs of comparison, although it is not entirely clear whether the two parts of the comparison criteria used by the ECJ are to be applied individually or cumulatively.[98] According to Hohenwarter, the reasoning of the Court is - in comparison to the statement of the Advocate General - 'less pronounced'.[99] It seems that also the Confédération Fiscale Européenne (CFE) ECJ Task Force came to the conclusion that the ECJ made such a horizontal comparison.[100] Other commentators, like Kessler, Eicke and also Kemmeren rejected the existence of a horizontal comparison in the *Cadbury Schweppes* case.[101]

Eventually, it is the *Columbus Container* decision which gives an answer to the question whether the horizontal comparison of the same form of establishment is required or not. In contrast to *Cadbury Schweppes*, the vertical comparison (here related to a permanent establishment) did not result in a different treatment. The ECJ concluded that the national legislation did not make a distinction between the income taxation of a domestic permanent establishment and the income taxation of a foreign permanent establishment which was subject to an income tax rate below 30 percent.[102] In a purely domestic situation, the income of the German permanent establishment would be added to the income of the resident taxpayer. In a cross-

[96] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 74.
[97] Case C-196/04 (*Cadbury Schweppes*), paragraphs 44, 45.
[98] Calderón / Baez, The *Columbus Container Services* ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle, Intertax 2009, page 212 et seq. (217); see in this respect also the Opinion of the Advocate General Mengozzi (case C-298/05 - *Columbus Container*), paragraph 119.
[99] Hohenwarter, The Allocation of Taxing Rights in the Light of the Fundamental Freedoms of EC Law, in Tax Treaty Law and EC Law, page 101.
[100] Opinion Statement of the CFE ECJ Task Force on ECJ, *Columbus Container Services BVBA & Co v. Finanzamt Bielefeld-Innenstadt*, 6 December 2007, C-298/05 - April 2008, European Taxation 2008, page 541 et seq. (542).
[101] Kessler / Eicke, The Egg of *Columbus Container*: German Budget Sunny Side Up, Not Scrambled, Tax Notes International 2008, page 589; Kemmeren, The Internal Market Approach Should Prevail over the Single Country Approach, in A Vision of Taxes Within and Outside European Borders. Festschrift in Honour of Prof. Dr. Frans Vanistendael, 2008, page 576.
[102] Case C-298/05 (*Columbus Container*), paragraphs 39, 40.

border situation, the foreign income - based on the respective legislation - would also be added to the domestic income of the resident taxpayer and an ordinary tax credit would have to be granted. Thus, given the fact that the vertical comparison did not result in a different treatment, it would have been necessary - *if the horizontal comparison of the same form of establishment was an acceptable and necessary method of comparison* - to proceed with the comparison of a foreign permanent establishment which is exempt from taxation in Germany (because the tax rate in the respective state is not below 30 percent) and a foreign permanent establishment which results in a switch-over from the exemption method to the credit method (because the tax rate in the respective state is below 30 percent).

Figure 6:



However, the ECJ did not make the horizontal comparison of the same form of establishment which, in my opinion, would have resulted in the identification of a different treatment. In other words, the limitation to a mere vertical comparison makes a real difference with respect to the identification of a different treatment - in contrast to the *Cadbury Schweppes* decision.[103] It was submitted by *Columbus* that the national legislation in question leads to a distortion of the choice which companies and partnerships have to establish themselves in different Member States.[104] However, the ECJ rejected this argument with reference to the fiscal autonomy of the Member States.[105] Therefore, it seems to be clear (now) from the *Columbus Container* decision that the horizontal comparison of the same form of establishment cannot be derived from EU law. It is worth mentioning that the ECJ, in its decision,

[103] See in this respect also the examinations made by Calderón and Baez in The *Columbus Container Services* ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle, Intertax 2009, page 212 et seq.
[104] Case C-298/05 (*Columbus Container*), paragraph 50.
[105] Case C-298/05 (*Columbus Container*), paragraph 51.

did not follow the Opinion of the Advocate General Mengozzi who concluded - also based on paragraphs 44 and 45 of the *Cadbury Schweppes* decision - that a horizontal comparison should be made.[106] In fact, a number of authors criticised the different outcome of *Cadbury Schweppes* and *Columbus Container*.[107] According to Calderón and Baez, the non-application of the ECJ's case law on anti-avoidance rules to a case such as *Columbus Container* is difficult to understand.[108] The Confédération Fiscale Européenne (CFE) ECJ Task Force comes to a similar conclusion. In their view, the ECJ should have taken the chance to make a more detailed and explanatory statement about the limits to the tax sovereignty of the Member States. If the Court had chosen the same comparator as in *Cadbury Schweppes*, the Court should then have enquired about possible justifications, in particular the need to prevent abusive practices. In contrast thereto, Meussen concluded that in *Columbus Container* no CFC legislation was at stake. Accordingly, the *Cadbury Schweppes* arguments do not apply in this case and it is not in violation of EU law to apply the credit method to counter low-tax jurisdictions, whilst, in general, foreign income is exempt from taxation.[109] In my opinion, it is not so much the question whether the national legislation in *Columbus Container* can be seen as 'quasi CFC rules' or not and whether, in case of a (theoretically) different treatment, the outcome would be similar to the outcome of *Cadbury Schweppes*. In fact, if the horizontal comparison is not possible, the outcome of the *Columbus Container* decision is - from a mere EU law perspective - completely understandable. However, I do not think that the *Columbus Container* decision is positive for the further development of an internal market, because it is obvious to me that such legislation can distort investment decisions - and this should not happen within an internal market. In other words, despite the fact that EU law apparently merely requires the vertical comparison and does not permit the horizontal comparison, it should still be the aim to eliminate any obstacles for an investment in another Member State. This, however, would be achieved much better with the admission of horizontal comparability. With respect to CFC cases, I fully agree with Advocate General Léger that if Member States were allowed to choose the other Member States in which its domestic companies may establish subsidiaries with the benefit of the tax regime applicable in the host Member State, this would "*manifestly lead to a result contrary to the very notion of 'single market'* ".[110]

[106] Opinion of the Advocate General Mengozzi (case C-298/05 - *Columbus Container*), paragraph 120.
[107] Calderón / Baez, The *Columbus Container Services* ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle, Intertax 2009, page 212 et seq. (218); Opinion Statement of the CFE ECJ Task Force on ECJ, *Columbus Container Services BVBA & Co v. Finanzamt Bielefeld-Innenstadt*, 6 December 2007, C-298/05 - April 2008, European Taxation 2008, page 541 et seq. (542, 543); Lang, Die Zukunft der Doppelbesteuerungsabkommen im Lichte von Columbus Container, in Festschrift für Wolfram Reiss: zum 65. Geburtstag, 2008, page 679 et seq. (693); de la Feria, Prohibition of Abuse of (Community) Law: The Creation of a New General Principle of EC Law through Tax, Common Market Law Review 2008, page 432.
[108] Calderón / Baez, The *Columbus Container Services* ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle, Intertax 2009, page 212 et seq. (218).
[109] Meussen, *Columbus Container Services* - A Victory for the Member States' Fiscal Autonomy, European Taxation 2008, page 169 et seq. (172).
[110] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 80; see in this respect also Calderón / Baez, The *Columbus Container Services* ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle, Intertax 2009, page 212 et seq. (215).

8.2.4.3. "Most-Favoured Nation" Treatment for CFC Investments?

It is questionable whether the theoretical acceptance of a horizontal comparison between the tax treatment of a domestic taxpayer with a secondary establishment in a Member State where the CFC rules are applicable and a domestic taxpayer with a hypothetical secondary establishment in a Member State where the CFC rules are not applicable leads to any further perception. As already outlined above, the comparison can make the restrictive effect much more obvious, e.g. if the tax rates in both Member States are lower than the tax rate in the country of primary establishment and if the difference in treatment is only due to the low-taxation threshold stipulated in the domestic CFC legislation. If an investor strongly focuses on a lower taxation, the Member State which does not trigger the CFC taxation will be much more attractive than the Member State which triggers the CFC taxation and perhaps even more attractive than the Member State of primary establishment. The latter state, however, typically has the "bonus" of a residence state since the investment in a foreign country may lead to additional risks and administrative burdens. However, when it comes to the question of a "most-favoured nation" treatment based on a double tax convention, it must be noted that CFC rules are merely domestic provisions which are often not even mentioned in double tax conventions. Thus, the double tax conventions concluded by the residence state of the shareholder - the state which applies the CFC rules - may be the same for Member States which trigger CFC taxation and those which do not trigger such taxation. The differentiation is therefore solely based on national legislation. No favourable treatment is stipulated in a double tax convention with one Member State which may theoretically be transferred to the relationship with another Member State - supposing that such a "most favoured nation" treatment can be derived from EU law at all. Up to now, the most favoured nation treatment was not accepted by the ECJ. In the *Columbus Container* decision and the *Block* decision, the ECJ made it clear that, in the current stage of the development of EU law, the Member States are not obliged to adapt their own tax systems to the different systems of tax of the other Member States.[111].

8.2.4.4. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

One of the important questions is whether the application of a system which solely focuses on the current taxation of the basic interest component may result in a restriction on one or more of the basic freedoms - similar to (or even exactly like) the restriction caused by the application of the "typical" CFC regimes. From a mere technical perspective, both systems lead to a current taxation of income, i.e. the income is immediately attributed to the shareholder. It was concluded above that - based on the jurisprudence of the ECJ - the "forced" attribution of income has a restrictive effect on investments in other countries (if the current attribution of income is not made in a non-discriminatory manner, i.e. if the legislation is not at the same time applicable in case of purely domestic investments). Thus, from a technical perspective there is, in principle, no substantial difference between an alternative system which focuses on the current taxation of the basic interest component and the CFC regimes outlined in chapter 6. Even if the alternative system does not result in

[111] Case C-298/05 (*Columbus Container*), paragraph 51, case C-67/08 (*Block*), paragraph 31. See with respect to the most-favoured nation treatment and double tax conventions case C-376/03 (*D*) paragraphs 61, 62 and case C-374/04 (*ACT*) paragraphs 88 to 91.

the serious disadvantages which were described in the latter chapter, e.g. the double taxation of income which is caused by the existence of tax losses and multiple tier structures, negative effects can remain for the shareholder which are related to an immediate increase of the tax rate imposed on the basic interest component. At least, this is true if the income of the subsidiary was subject to a lower taxation than in the state of residence of the shareholder and, based on the theoretical concept, the state where the income was produced. However, the latter effect is inherent in the system and is exactly what is intended by the application of such an alternative legislation. I have already outlined earlier that there are important reasons from an economic and equity perspective to follow such a concept and I will come back to such a "limited" capital export neutrality approach in the EU context in some more detail below. However, if one follows the jurisprudence of the ECJ and its strict approach in this respect, it is very likely - despite all the positive aspects - that the alternative system would be qualified as having a restrictive effect on investments as well.

8.2.5. Justifications for Restrictions Caused by CFC Legislation

The arguments for a justification of a restriction on the basic freedoms which played a role in the case law of the ECJ and which may be relevant in the context of this study were outlined in some detail in chapter 4. It is, of course, theoretically possible that additional arguments will be put forward in a case dealing with CFC legislation - depending on the facts and circumstances of the underlying case. In the following, the arguments which might come up in CFC cases will be examined in some more detail. It will be verified whether a restriction on basic freedoms caused by the application of CFC rules and the application of an alternative system which focuses on the current taxation of the basic interest component may be justified under the rule of reason.

8.2.5.1. The Cohesion of the Tax System

Based on the examinations in chapter 4, the cohesion argument is not limited (anymore) to 'one and the same taxpayer' and 'one and the same tax,' but can also be relevant in a parent-subsidiary relationship. However, the question arises whether there can be a direct link between a tax advantage and disadvantage in CFC cases. Can the lower taxation in another country be considered, in general, as a "tax advantage" which should be "compensated" by a "tax disadvantage" in the residence state of the shareholder? I do not think that this can be assumed and I do not see any direct link between the "advantage" of a lower tax rate in another country and the compensating taxation of the shareholder. Furthermore, such a general compensation would not be in line with the principle of proportionality, which is equally relevant for a justification based on fiscal cohesion.[112] Otherwise, any activity in a country with a lower taxation and within the broad range of activities which are marked as passive activities or base company activities would generally be subject to a compensatory taxation according to the principle of fiscal cohesion. In the *Cadbury Schweppes* case, the ECJ did not deal with the justification based on fiscal cohesion and it seems, therefore, that it will not play any role in CFC cases.

[112] See with respect to the UK CFC legislation also Körner, Europarecht und CFC-Regelungen - Anrufung des EuGH im Verfahren "Cadbury Schweppes," Internationales Steuerrecht 2004, page 697 et seq. (702); case C-436/00 (*X and Y*), paragraph 59.

8.2.5.2. The Loss of Tax Revenue and the Erosion of the Tax Base

It is likely that Member States which offer lower income tax rates than other Member States attract capital investments from countries within the EU and from countries outside the EU. From the perspective of the Member States with a comparably high tax rate this may result in a loss of tax revenue and an erosion of the domestic tax base. CFC legislation is considered an instrument to avoid this effect by attributing the income derived through the foreign low-taxed company to the domestic taxpayer. The avoidance of a loss of tax revenue and an erosion of the tax base was often put forward in cases before the ECJ as a justification for restrictive measures of Member States. However, it is settled case law that this does not constitute a matter of overriding reason of public interest which may be relied upon in order to justify a restriction on the basic freedoms.[113] In the *de Lasteyrie du Saillant* case the ECJ basically accepted that unrealised reserves included in the shares may be transferred from France to another country which may ultimately result in a non-taxation of the reserves. In case of CFC rules, the transfer of unrealised reserves does not play a (comparable) role. The CFC rules focus on income derived by the foreign company, i.e. the income is generated only after the actual foreign investment was made. In my opinion, there is a difference in quality between the two concepts and it is therefore very unlikely that a loss of tax receipts might be accepted by the ECJ in a CFC case - taking into account the outcome of the *de Lasteyrie du Saillant* case and the general non-acceptance in the other decisions.[114]

8.2.5.3. The Lower Taxation in the CFC Country

A justification which is based on a lower (or different) taxation in the other Member State can be of particular relevance in a CFC case. Based on the earlier examinations, the CFC rules of the Member States are only applicable in case of a lower taxation compared to the Member State which applies the respective rules, i.e. the income tax rate in the CFC country must to a certain extent deviate from the domestic income tax rate (or income tax burden). It is therefore likely that - in addition to the more general argument of a loss of tax revenue and an erosion of the domestic tax base - the argument of a lower taxation may play a separate role. Without any doubt, a compensatory taxation will not be accepted by the ECJ. This is clear from the existing case law related to the general compensation for advantages and the specific compensation for a lower (or different) taxation in another Member State.[115] Furthermore, the ECJ explicitly stated in the *de Lasteyrie du Saillant* case that a loss of receipts caused by the movement of a taxpayer to another Member State which provides a tax system which is more advantageous for him cannot in itself justify a

[113] Case C-35/98 (*Verkooijen*), paragraph 48; case C-436/00 (*X and Y*), paragraph 50; case C-484/93 (*Svensson and Gustavsson*), paragraph 15; see also case C-288/89 (*Stichting Collectieve Antennevoorziening Gouda and Others v Commissariaat voor de Media*), paragraph 11; case C-120/95 (*Decker)*, paragraph 39; case C-158/96 (*Kohll)*, paragraph 41; case C-264/96 (*ICI*), paragraph 28, case C-397/98 and C-410/98 (*Metallgesellschaft and Others*), paragraph 59; case C-307/97 (*Saint-Gobain*), paragraph 50; case C-136/00 (*Danner*), paragraph 56; case C-422/01 (*Skandia*), paragraph 53; case C-315/02 (*Lenz)*, paragraph 40; case C-319/02 (*Manninen*), paragraph 49; case C-168/01 (*Bosal Holding*), paragraph 42; case C-9/02 (*de Lasteyrie du Saillant*), paragraph 60.

[114] See the references in the previous footnote.

[115] With respect to the general compensation for advantages see case C-307/97 (*Saint-Gobain*), paragraph 51 and case C 270/83 (*Commission v France*), paragraph 21. With respect to the lower (or different) taxation see, in particular, case C-294/97 (*Eurowings*), paragraphs 43 to 45. The conclusions from *Eurowings* were confirmed in subsequent decisions, e.g. case C-422/01 (*Skandia*), paragraph 52; case C-136/00 (*Danner*), paragraph 56; case C-364/01 (*Barbier*), paragraph 37.

restriction on the right of establishment.[116] Why should this be different in case of an investment in a CFC country?

It was rather obvious that the tax rate would play a role in the *Cadbury Schweppes* case. In his Opinion to the case, Advocate General Léger made some general statements in this respect. He held that *"(...) it may also be inferred from the case-law that a Member State cannot hinder the exercise of the rights of freedom of movement in another Member State by using the pretext of a low level of taxation in that State."*[117] And *"(...) in the absence of Community harmonisation it must be accepted that there is competition between tax regimes of the various Member States. That competition, which is reflected in particular by great disparity between the Member States in the rates of taxation of company profits, may have a significant impact on the choice of location made by companies for their activities in the European Union. It may be regrettable that competition operates between the Member States in this field without restriction. That is, however, a political matter."*[118] He also referred to the code of conduct and made it clear that the fact that the national legislation in question was identified as a harmful measure in the report of the Code of Conduct group cannot influence the scope of the rights conferred on economic operators by Articles 43 and 48 of the EC Treaty (now Articles 49 and 54 of the TFEU).[119] The same is true with respect to state aid: *"(...) the Treaty contains specific provisions, in Articles 87 EC and 88 EC, intended to check the compatibility of such a measure with the common market and to eliminate its harmful effects on that market. The fact that such a system does not comply with the rules of the Treaty cannot therefore entitle a Member State to take unilateral measures intended to counter its effects by limiting freedom of movement."*[120] Overall, Advocate General Léger concluded that *"(...) the harmful effects of a total absence of harmonisation of the rates of taxation of company profits call (...) for a political solution and do not appear to justify, in my opinion, calling into question the scope of the rights conferred by Articles 43 EC and 48 EC, as defined by case-law. I therefore find that the establishment by a company which is resident for tax purposes in a Member State of a subsidiary in the International Financial Services Centre for the avowed purpose of enjoying the more favourable tax regime applicable there does not, in itself, constitute an abuse of freedom of establishment."*[121]

In the context of examining the hindrance to the freedom of establishment, the Advocate General outlined that - in response to the argument that the disparity in the rates of corporation tax constituted an objective difference which, therefore, justified the differentiated treatment - such argumentation *"(...) would be tantamount to conceding that a Member State is entitled, without infringing the rules of the Treaty, to choose the other Member States in which its domestic companies may establish subsidiaries with the benefit of the tax regime applicable in the host State. However, as the applicants and Ireland have submitted, such a situation would manifestly lead to a result contrary to the very notion of 'single market.' The fixing of rates of corporation tax falls (...) within the unfettered competence of each Member State and Articles 43 EC and 48 EC confer on every company in accordance with Article 48 EC*

[116] Case C-9/02 (*de Lasteyrie du Saillaint*), paragraph 60.
[117] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 54.
[118] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 55.
[119] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 56, 57.
[120] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 58.
[121] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 60.

the right to set up a subsidiary in the place of its choice within the Union. A Member State may not, therefore, treat differently its resident companies which establish subsidiaries in other Member States depending on the tax rate applicable in the host State. That interpretation would also run counter to the approach adopted by the Court in Eurowings Luftverkehr and Barbier, in which it was held that low taxation applicable in a Member State cannot justify unfavourable tax treatment by another Member State and a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence."[122] In general, the ECJ followed the Opinion of the Advocate General and confirmed the (aforementioned) previous jurisprudence. The Court stated that *"(t)he United Kingdom, supported by the Danish, German, French, Portuguese, Finnish and Swedish Governments, submits that the legislation on CFCs is intended to counter a specific type of tax avoidance involving the artificial transfer by a resident company of profits from the Member State in which they were made to a low-tax State by means of the establishment of a subsidiary in that State and the effecting of transactions intended primarily to make such a transfer to that subsidiary. In that respect, it is settled case-law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company.*" [123] It is therefore quite obvious that the mere fact that the tax rate is different in another Member State cannot be an acceptable justification for any restriction on the basic freedoms.

8.2.5.4. The Principle of Territoriality

As already outlined in chapter 4, it should be clear that it is impossible to deduce from the territoriality principle that profits and losses accruing to different taxpayers can be offset against each other.[124] In case of CFC legislation, however, the income realised by a different taxpayer (subsidiary company) - resident in another country - is attributed to the domestic shareholder (parent company). Such an income attribution cannot be based, in my opinion, on the principle of territoriality. The income is economically and legally allocable to the subsidiary company and therefore subject to tax in the CFC country. Clearly, the income of the subsidiary company which is related to the activities in the Member State of the parent company can be taxed in the latter country in case of a permanent establishment. This, however, is a different situation. The principle of territoriality is therefore rather an argument *against* CFC taxation instead of a valid justification for the application of those rules. It is rather the contrary argument of world-wide taxation, i.e. the economic principle of capital export neutrality, which can be expected in a CFC case. This, however, will be examined separately.

[122] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 79 to 82.
[123] Case C-196/04 (*Cadbury Schweppes*), paragraphs 48, 49.
[124] See the Opinion of Advocate General Alber (case C-168/01), September 24, 2002, paragraphs 66, 67; case C-168/01 (*Bosal Holding*), paragraph 38.

8.2.5.5. The Protection of a Balanced Allocation of the Power to Impose Taxes between Member States

The protection of a balanced allocation of the power to impose taxes between Member States can, in my opinion, not be put forward as a valid argument in CFC cases. In fact, the allocation of the income which is related to the activity component and the risk component leads to the result that foreign income is taxed in the hands of the shareholder which should be, in my opinion, outside of the scope of taxation in the residence state of the shareholder. Moreover, chapter 6 shows that CFC rules can lead to a number of disadvantages for the taxpayer and often provide for a different treatment of positive and negative CFC income. Such regimes do not contribute, therefore, to a symmetrical system of taxation. In other words, the income derived through a CFC is by no means treated 'as if the profits and losses are two sides of the same coin'.[125] The balanced allocation of power is therefore rather an argument *against* the application of CFC regimes, but cannot be put forward in favour of the application of such regimes.

8.2.5.6. The Effectiveness of Fiscal Supervision

The justification which is based on the effectiveness of fiscal supervision was rejected in a number of cases.[126] The reason is that the Council Directive 77/799/EEC concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation provides sufficient means to obtain all the necessary information related to the investment in other Member States.[127] However, it was outlined in chapter 4 that the Council Directive 77/799/EEC is only of relevance in the relationship between Member States and, therefore, a differentiation can be required with respect to a justification for a restriction in case of an investment in another Member State and an investment in a third country.[128] Moreover, the fact that the obligation of information exchange may also be stipulated bilaterally, e.g. in double tax conventions, between Member States and between Member States and third countries, makes it - in my opinion - also necessary to differentiate between third countries. However, I will deal with the justifications in the context of investments in third countries separately in some more detail below.

In principle, if the situation is related to an investment in another Member State there is nothing to prevent the tax authorities from requiring the taxpayer himself to provide all the necessary information related to his investments.[129]. Thus, if the focus is just on the investment in other Member States, the question arises whether the aforementioned tools (Council Directive 77/799/EEC, double tax convention, obligation of the taxpayer based on domestic legislation to provide all of the required information) are not less restrictive means to ensure the effectiveness of fiscal supervision than the application of CFC rules. In the *Cadbury Schweppes* case, the

[125] See in this respect case C-446/03 (*Marks & Spencer*), paragraphs 43 to 46.
[126] See in this respect chapter 4 of the study.
[127] Council Directive 77/799/EEC, December 19, 1977, OJ 1977 L 336, page 15.
[128] See in this respect case C-446/04 (*Test Claimants in the FII Group Litigation*), paragraph 171; case C-101/05 (*A*), paragraphs 36, 60 and 63; case C-540/07 (*Commission v Italy*), paragraph 69; case C-72/09 (*Rimbaud*), paragraphs 47 to 51.
[129] Case C-240/90 (*Bachmann*), paragraphs 18-20; case C-279/93 (*Schumacker)*, paragraph 45; case C-55/98 (*Vestergaard*), paragraphs 25-28; case C-80/94 (*Wielockx*), paragraph 26; case C-136/00 (*Danner*), paragraphs 49 and 50; case C-422/01 (*Skandia*), paragraphs 42 and 43; case C-150/04 (*Commission v Denmark*), paragraph 54; case C-451/05 (*ELISA*), paragraph 95.

Irish Government put forward such an argument - which, however, was not directly linked to the effectiveness of fiscal supervision - and stated that the objective pursued by the United Kingdom CFC legislation could be attained by less restrictive measures, namely the exchange of information under Council Directive 77/799/EEC and the double tax convention concluded between the United Kingdom and Ireland.[130] In his response to that argument, the Advocate General held that *"(i)n view of the particular situation covered by the legislation in question, however, I am not convinced that exchange of information under Directive 77/799 could be as effective as the legislation at issue. Likewise, I do not share the view that that legislation should be regarded, owing to the presumption it introduces, of imposing an unreasonable burden on the companies to which it applies*"[131] And *"(...) given the ease with which such services can be relocated, I do not find it excessive for a Member State to introduce a presumption of tax avoidance instead of relying on the subsequent communication of information. Second, the existence of such legislation has the advantage of contributing to the legal certainty of economic operators. It enables them to know in advance that, in the aforementioned case, there is a presumption of tax avoidance. Those operators are thus on notice that they must be able to show that their subsidiary is genuinely established in the host State and that the transactions with the subsidiary are real."*[132] In this respect, it is important to note that the United Kingdom CFC legislation provides a substantial number of exceptions from current taxation. It is therefore likely that the number of potentially wholly artificial arrangements increases within the remaining types of investment (after the "filtering"). Here, the domestic taxpayer has the burden of proof and must show that the investments are in fact not wholly artificial arrangements but genuine activities which are carried out in the host Member State. Such an approach does not seem, in general, to be unreasonable. It was already determined in the *Marks & Spencer* case that - as a less restrictive measure - the taxpayer might be required to demonstrate that certain conditions are fulfilled in order to be allowed to deduct losses incurred by its non-resident subsidiaries.[133] I agree with the position of the Advocate General that a system which is based on information exchange is definitely less effective than the application of CFC rules. Again, the argumentation was not explicitly based on the effectiveness of fiscal supervision, but it goes in a similar direction.

8.2.5.7. The Aim of Preventing Tax Avoidance

In the following, the justification which is based on the aim of preventing tax avoidance in CFC cases will be examined separately for the freedom of establishment and the free movement of capital. It is not required, in my opinion, to discuss the justification which is based on the aim of preventing tax avoidance separately for the freedom to provide services. In this regard, the result under Article 56 of the TFEU should not be different from the result under Article 49 of the TFEU.

a.) The freedom of establishment

With respect to CFC legislation it is again quite informative to have a look at the *de Lasteyrie du Saillant* case. Here, the ECJ criticised that the French legislation in question cannot *"(…) without greatly exceeding what is necessary in order to achieve*

[130] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 134.
[131] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 136, 137.
[132] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 140, 141.
[133] Case C-446/03 (*Marks & Spencer*), paragraphs 55, 56.

the aim which it pursues, assume an intention to circumvent French tax law on the part of every taxpayer who transfers his tax domicile outside France. Similarly, a taxpayer who sells his securities before the expiry of the five-year period following his departure from France will also be liable for the tax (…), even if he has no intention of returning to that Member State (…). Moreover, the objective envisaged, namely preventing a taxpayer from temporarily transferring his tax residence before selling securities with the sole aim of avoiding payment of the tax on increases in value due in France, may be achieved by measures that are less coercive or less restrictive of the freedom of establishment, relating specifically to the risk of such a temporary transfer. As the Advocate General has pointed out in paragraph 64 of his Opinion, the French authorities could, for example, provide for the taxation of taxpayers returning to France after realising their increases in value during a relatively brief stay in another Member State, which would avoid affecting the position of taxpayers having no aim other than the bona fide exercise of their freedom of establishment in another Member State. "[134] Pursuant to the Advocate General, *"(t)he return after a short stay would show that it was temporary and would thwart exactly the conduct complained of by the French authorities, without affecting the situation of taxpayers whose only aim is to exercise in good faith their freedom of establishment (…). By collecting the tax on the date of return, which would take place, by definition, shortly after the sale of the shares in the course of a brief stay in another Member State, the Member State concerned would, so to speak, draw the appropriate conclusion from the sham location where the capital gain is realised in another Member State by treating it as if it had actually taken place in France."*[135] Leaving aside the fact that such a legislative concept might be in conflict with a double tax convention concluded between France and the other Member State,[136] the decision shows that it is clearly required to narrow the scope of the respective legislation to those cases in which the probability of abuse is very high. The fact that the taxpayer moves to another Member State, disposes his shares, and returns to France after a short stay in the other Member State is not necessarily an abusive arrangement. Therefore, the proposed legislation does not completely eliminate the possibility of arrangements being covered by the legislation which are not wholly artificial. However, the decision confirms the outcome of previous cases: legislation which generally applies to a great number of situations which are not aimed at the circumvention of domestic law cannot be justified by the aim of preventing tax avoidance.[137]

Obviously, the focus on 'wholly artificial arrangements' also plays a key role in CFC cases. In this respect, it is again of great interest to have a look at the *Cadbury Schweppes* case and the position of Advocate General Léger in his Opinion to the case. It is clear from the case that the purpose of the United Kingdom CFC legislation is to "*counteract tax avoidance*."[138] The Advocate General made therefore a detailed verification whether the hindrance to the freedom of establishment may be justified by the counteraction of tax avoidance. In this respect, he made it clear that focusing on wholly artificial arrangements in the case law of the ECJ may be understood as being intended to prevent the counteraction of tax avoidance from being used as a pretext

[134] Case C-9/02 (*de Lasteyrie du Saillant*), paragraphs 52 to 54.
[135] Opinion of the Advocate General Mischo (case C-9/02), March 13, 2003, paragraph 64.
[136] At least in those cases where the taxpayer becomes a resident of the other Member State.
[137] See, *inter alia*, case C-264/96 (*ICI*), paragraph 26; case C-436/00 (*X and Y*), paragraph 61; case C-324/00 (*Lankhorst-Hohorst*), paragraph 37; case C-9/02 (*de Lasteyrie du Saillant*), paragraph 50.
[138] Opinion of the Advocate General Mischo (case C-9/02), March 13, 2003, paragraph 2.

for protectionism.[139] An acceptable anti-avoidance legislation must, therefore, be concentrated on specific situations and arrangements and cannot be applied generally to a great number of situations which are not aimed at circumventing the law. In any event, the provision of genuine services by a subsidiary company to the parent company cannot be regarded, in itself, as tax avoidance.[140] Those services will be determined under normal competitive conditions, i.e. transfer pricing rules apply to the provision of such inter-company services.[141] The Advocate General therefore made a clear distinction between the services in question and the situation in the *Marks & Spencer* case where the ECJ accepted that the transfer of losses of a non-resident subsidiary to a resident parent company entails the risk of tax avoidance.[142] He stated that *"(t)he risk of tax avoidance in connection with such transactions is not therefore comparable to that which would be created by the transfer of losses of foreign subsidiaries to a resident parent company, at issue in the Marks and Spencer case, (...) since such a transfer of losses would be done by means of merely adjusting the accounts. Transactions between a CFC and its parent company which result in reducing the taxable profits of the latter can therefore be regarded as tax avoidance only if the establishment of that subsidiary and those transactions constitute (...) a wholly artificial arrangement aimed at circumventing national legislation. Likewise, in my view, the fact that a company centralises in another Member State with a low tax rate the carrying on of certain activities of use to the entire group and seeks by that means to reduce the group's overall tax burden does not in itself constitute abuse. In such a case, as long as the subsidiary responsible for those intragroup services is carrying on genuine economic activity in the host State, under the tax sovereignty of which it falls, the territorial allocation of the Member States' power to impose taxes is not, a priori, affected. The loss of taxable profits affecting the State of origin is the result of the economic activity which is carried out in the host State and taxed by that State*."[143] The assessment whether there is a wholly artificial arrangement or not must be made on a case-by-case basis and cannot be generalised. The criteria which can be used for the separation between wholly artificial arrangements and non-artificial arrangements have been outlined earlier in some detail.

The Advocate General examined further whether the United Kingdom CFC legislation is *suitable* for counteracting tax avoidance and whether it goes *beyond what is necessary* for that purpose. In this respect, it is not surprising that the legislation is considered to be suitable for guaranteeing the fulfilment of the purpose - given the fact that the low-taxed profit of the CFC is included in the domestic tax base of the parent company.[144] Such an approach completely eliminates the effect of a lower taxation in the other country. The question whether the legislation goes beyond what is necessary to achieve that purpose is more sophisticated. As already mentioned earlier, the United Kingdom CFC legislation - in the version which was relevant for the decision in *Cadbury Schweppes* - provided a substantial number of exceptions to the current taxation of income. The CFC income was not subject to current taxation if the subsidiary followed an 'acceptable distribution policy', was engaged in certain

[139] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 87, 88.
[140] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 106, 107.
[141] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 108; see the reference to the OECD Transfer Pricing Guidelines.
[142] Case C-446/03 (*Marks & Spencer*), paragraphs 49, 50.
[143] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 108, 109.
[144] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 125.

'exempt activities', satisfied the 'public quotation condition', or the chargeable profits did not exceed a certain threshold. In addition, the legislation provided a 'motive test' which led to an exception from current taxation if the taxpayer fulfilled two conditions (i.e. both conditions had to be fulfilled at the same time):

- the taxpayer must show that the reduction in United Kingdom tax was not the main purpose, or one of the main purposes, of those transactions; and

- the taxpayer must show that it was not the main reason, or one of the main reasons, for the subsidiary's existence in the accounting period to a achieve a reduction in United Kingdom tax by means of the diversion of profits. According to the legislation, a diversion of profits exists if it is reasonable to suppose that, had the subsidiary or any related non-United Kingdom resident company not existed, their receipts would have been received by, and been taxable in the hands of, a United Kingdom resident.[145]

Given the ease with which such inter-company services can be relocated to other (low-tax) countries, the number of exceptions provided by the United Kingdom CFC legislation, and the fact that other measures - like information exchange based on the Council Directive 77/799/EEC and on the respective double tax convention - are less effective, the Advocate General does not consider it excessive to introduce a presumption of tax avoidance instead of relying on the subsequent communication of information.[146] As already stated earlier, the fact that the CFC regime only applies to low-tax countries and the fact that it offers a substantial number of exceptions ensures that there is a "filtering" of investments. In my opinion, the better the filtering, the higher the percentage of potentially wholly artificial arrangements in the remaining "basket of investments." However, this exactly is, in my opinion, the crucial aspect: if there is no real filtering of investments, because the legislation is often applied in an undifferentiated way to investments in low-tax countries, the respective legislation cannot be considered to specifically focus on wholly artificial arrangements. On the other hand, even if the legislation provides a substantial number of exceptions, it cannot be excluded that investments which remain in the basket are nonetheless genuine activities which are carried out in the host Member State and which are far from having to be classified as wholly artificial arrangements. Therefore, it is unavoidable - and this is also the conclusion of the Advocate General - that there is a real possibility to show that the investments which remain in the basket (after the filtering) are nonetheless genuine activities. Hence, the Advocate General stated that *"(...) what is important is that the presumption set up by the law in question may in fact be rebutted. As several Member states and the Commission have rightly noted, the fact that none of the first four exceptions apply and that the transactions between the subsidiary and its parent company have resulted in a significant reduction in the tax due in the United Kingdom does not suffice to show the existence of a wholly artificial arrangement*."[147] And *"(...) the taxable person must be able to provide that proof in accordance with the rules of evidence under national law, provided that the effectiveness of Community law is not thereby undermined*."[148] The decisive question in case of the United Kingdom CFC legislation is therefore

[145] It has to be noted, though, that the United Kingdom CFC legislation will be amended significantly. This will be outlined in section 8.5.4.
[146] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 136 to 140.
[147] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 143.
[148] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 145.

whether the 'motive test' enables the taxpayer to provide this proof. From the perspective of the Advocate General, it is not sufficiently clear whether the motive test really provides for such a possibility. Thus, he concluded that *"(...) we do not know for sure if the first limb of that test, regarding the services which have resulted in a significant reduction in the tax due in the United Kingdom, enables the taxpayer to exempt itself by providing proof of the reality of those services. Likewise, it is not clear whether the second limb relates to the subjective motives of those concerned or whether it can be satisfied where the taxpayer proves that the subsidiary is genuinely established in the host State. At this stage I am of the opinion that it is for the national court, which has the tax of determining the compatibility with Community law of its national law on CFCs, to assess whether the motive test may be given an interpretation which makes it possible to limit the application of that law to artificial arrangements intended to circumvent national law.*"[149]

It is not surprising that the ECJ - in the decision to the *Cadbury Schweppes* case - went exactly into the same direction. The Court confirmed, once more, that the mere fact of establishing a subsidiary company in another Member State cannot set up a general presumption of tax evasion or tax avoidance.[150] A national measure restricting the freedom of establishment can be justified, though, if it specifically relates to wholly artificial arrangements aimed at circumventing national legislation.[151] Thus, if the CFC is just a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State - like, for example, in case of a 'letterbox' or 'front' subsidiary - it must be regarded as a wholly artificial arrangement which can be subject to CFC taxation. In contrast thereto, the investment must be excluded from CFC taxation if, despite the existence of tax motives, the incorporation of the CFC reflects economic reality.[152] The Court stated that *"(t)he resident company, which is best placed for that purpose, must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine.*"[153] This is, in my opinion, a very important and far reaching conclusion, because it makes it necessary, as already outlined above, that CFC legislation provides the possibility of rebutting the presumptions. However, such a possibility is usually not provided by CFC regimes - as described in chapter 6 - and it seems to me that it is not necessarily provided by the United Kingdom motive test, either. The reason is very simple: there may still be a genuine economic activity in the host Member State despite the fact that the main reasons for the structure were tax reasons. However, the ECJ concluded that it is up to the national court to determine whether the motive test leads to an interpretation which enables the taxation provided for by that legislation to be restricted to wholly artificial

[149] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraphs 149, 150. The fact that the Advocate General refers in paragraph 150 to "artificial arrangements" instead of "wholly artificial arrangements" (like in paragraph 108) should not be of any relevance, because he finally concluded that the focus must be on "wholly artificial arrangements" (see paragraph 152). The ECJ does not consistently stick to the latter term in its subsequent case law, either. For example, in the *SGI* decision (case C-311/08) the ECJ used the word "purely" instead of "wholly" (paragraph 66) and even omitted the words "purely / wholly" and only referred to "artificial arrangements" (paragraphs 67, 71). However, in those situations where it was omitted the ECJ referred to previous decisions which included the words "purely / wholly"(e.g. the reference in paragraph 67 of the *SGI* decision to paragraph 58 of the *Oy AA* decision). In my view, the fact that the words "purely / wholly" were omitted from time to time should not be understood as a change in the case law of the ECJ.
[150] Case C-196/04 (*Cadbury Schweppes*), paragraph 50.
[151] Case C-196/04 (*Cadbury Schweppes*), paragraph 51.
[152] Case C-196/04 (*Cadbury Schweppes*), paragraphs 65 to 68.
[153] Case C-196/04 (*Cadbury Schweppes*), paragraph 70.

arrangements.[154] With respect to the United Kingdom CFC regime and the interpretation of the motive test it is therefore interesting to follow the (domestic) developments in the *Vodafone* case. Here, the High Court decided that *Vodafone* does not have to pay UK corporation tax on the attributed CFC income after the *Cadbury Schweppes* decision. The Court of Appeal overturned this decision and ruled that the United Kingdom CFC regime should be interpreted as if it had a new exception for companies established in the EEA which carry on 'genuine economic activities' there. This means that the CFC rules will still apply to companies outside the EEA and also to EEA companies without genuine economic activities.[155] In essence, the exception based on a genuine economic activity is therefore to be seen differently from the motive test established in the United Kingdom CFC legislation.

The question arises whether the strict limitation for the application of CFC rules to 'wholly artificial arrangements' is still valid after the more recent ECJ decisions in the field of indirect taxation (the *Part Service* case and the *Ampliscientifica* case) and direct taxation (the *Oy AA* case*).* In this regard, I have outlined in section 4.2.9. that a differentiation is required between the concept of abuse in cases dealing with indirect taxation and cases dealing with direct taxation. In VAT cases, the national court has to make an overall assessment and has to decide whether the tax motive is essential compared to other non-tax explanations (such as economic objectives). For this reason, the structure can be considered abusive from a VAT perspective despite the fact that economic objectives exist (if the tax reasons are the principal aim of the structure).[156] In contrast thereto, if a CFC is genuinely established in another state, it does not play a role whether or not the saving of (income) taxes was the principal aim of the relocation.[157] In the latter case, it is only decisive whether or not the CFC is genuinely established in the other state. For this reason, I do not see that the more recent decisions of the ECJ in VAT cases change the outcome with respect to CFC investments.

It is important to note, though, that in the *Oy AA* case - a case dealing with direct taxation - the ECJ considered the Finnish legislation in question to be proportionate despite the fact that the legislation was not restricted to wholly artificial arrangements. However, there are important aspects which have to be considered:

- The Finnish legislation in the *Oy AA* case provided the possibility of making an intra-group financial transfer from the subsidiary company to the parent company (and vice versa) which can be treated - for tax purposes - as an expense of the transferor and income of the transferee. This gives the taxpayer(s) the opportunity to transfer income between group companies almost without any limitation. The financial transfer is neither related to the supply of services nor similar transactions and would not be restricted - in an international context - by transfer pricing rules.[158] It is therefore obvious that the unrestricted acceptance of such legislation in a cross-border situation would allow the taxpayer(s) to shift income freely from the state which applies

[154] Case C-196/04 (*Cadbury Schweppes*), paragraph 72.
[155] See for further details: United Kingdom, *Vodafone* Loses UK Tax Appeal, European Tax Service (May) 2009; see in this context also Coutinho, *Vodafone 2*: Does it Matter?, Tax Planning International Review (July) 2008.
[156] See case C-425/06 (*Part Service*), paragraph 62.
[157] See the references in section 4.2.9.
[158] At least not from the perspective of the state which applies such legislation.

such legislation to other states where group companies are established. Overall, it can be summarised that the Finnish legislation in the *Oy AA* case - applied in an international context - would provide almost unlimited possibilities of transferring income from Finland to other states and to reduce the Finnish tax base.

- In my opinion, the most obvious justification for the restriction on the freedom of establishment caused by the Finnish legislation is the safeguarding of the balanced allocation of power to impose taxes between Member States. I have already made it clear in section 4.2.10.3.8. that, in my opinion, it was unnecessary to create a link to the justification based on the aim of preventing tax avoidance. In essence, the safeguarding of the balanced allocation of the power to impose taxes requires that not only the transfers without any economic reality are restricted, but also the transfers with an economic reality. For example, there may be very important and valid economic reasons why *Oy AA* transfers financial means to the company in the UK. However, in both cases it is difficult to argue that the Finnish domestic tax base has (necessarily) to be reduced by the amount of financial transfer. For this reason, the Finnish legislation - applied cross-border - may involve tax avoidance schemes, but this is only a part of the whole picture. It is therefore logical that the legislation cannot be specifically designed to target wholly artificial arrangements, because it must also exclude other (non-artificial) transfers from the tax advantage. Hence, it is completely misleading to put forward the aim of preventing tax avoidance in a situation in which another justification, namely the safeguarding of the power to impose taxes between Member States, requires a much broader scope. For this reason, I do not see that the settled case law with respect to the aim of preventing tax avoidance and the necessity of specifically designed measures to target wholly artificial arrangements was changed by the *Oy AA* decision.

- The impact of CFC investments is by no means comparable to the impact which the Finnish legislation might have in an international context. CFC investments can lead to a transfer of income only by way of relocating functions and risks to another company in another state, but not merely because of an ‘income transfer’ decided by the taxpayer. The protection of the balanced allocation of the power to impose taxes is therefore, as already outlined above, of no relevance in case of CFC investments.

b.) The free movement of capital

Based on the earlier conclusions, the investment in the CFC will not be within the scope of the freedom of establishment but can be within the scope of the free movement of capital if the shareholder has just a minority interest in the CFC which does not provide definite influence over the company’s decisions. In my opinion, the outcome in such a situation should not be different. The taxpayer should still have the possibility to provide the proof that it is not just a wholly artificial arrangement. If the shareholder is able to do so, there is no possibility of treating the investment in the CFC different from any other domestic investment (or an investment in a third Member State) where the CFC rules are not applicable. Thus, if such an approach is appropriate and proportionate in the context of the freedom of establishment, there is no reason, in my opinion, why it should be different for the free movement of capital.

The fact that the latter basic freedom does not explicitly require the carrying out of an economic activity does not change anything: if the CFC provides services to the shareholder, as is the case in *Cadbury Schweppes*, the aforementioned principles have to be fulfilled. The fact that Article 63 of the TFEU is affected and not Article 49 of the TFEU - because of the lack of definite influence over the company's decisions - should not lead to the outcome that there are less restrictive criteria with respect to the genuine establishment of the CFC in the other state. The fulfilment of the criteria shows that the CFC provides genuine services from within the state of establishment and, therefore, does not require any application of an anti-avoidance legislation (because there is no tax avoidance).

If, for example, the sole purpose and activity of a subsidiary company in another state is the holding of certain assets without exercising any other functions, it has to be concluded - based on the principles outlined earlier - that this cannot be considered an economic activity and, therefore, does not fall within the scope of the freedom of establishment. However, the investment can be covered by the free movement of capital since the exercising of an economic activity is not one of the requirements in order to come within the scope of Article 63 of the TFEU. However, this does not answer the question whether the anti-avoidance legislation can be applied on the income derived from the mere holding of assets or not. Here, the conclusions from the *Cadbury Schweppes* decision are equally important and relevant. For example, if it turns out that there is no physical presence of the CFC in the other state it can hardly be argued - under such circumstances - that the avoidance of income taxation in the state of residence of the shareholder must be accepted by the latter Member State. In such a case, the presumptions provided by CFC regimes are acceptable, in the same way as outlined above, and the taxpayer is obliged - and must have the right - to provide the proof that the structure in question is not a wholly artificial arrangement.

8.2.5.8. The Principle of World-Wide Taxation

It is obvious, in my opinion, that the principle of world-wide taxation (or fiscal neutrality) might be put forward as an argument for the application of CFC rules. The concept of world-wide taxation is based on the economic principle of capital export neutrality which was outlined in the earlier chapters. It is, in general, true that the ECJ accepted the principle of world-wide taxation and the OECD tax credit system as a method of eliminating double taxation within the EU in a number of cases.[159] However, this does not necessarily result in the acceptance of a regime which focuses on the piercing of the corporate veil of non-resident companies. In the *Gilly* case, for example, the Court stated that *"(w)hilst abolition of double taxation within the Community is (…) one of the objectives of the Treaty, it must none the less be noted that (…) no unifying or harmonising measure for the elimination of double taxation has yet been adopted at Community level, nor have the Member States yet concluded any multilateral convention to that effect under Article 220 of the Treaty. The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation - by means, inter alia, of*

[159] Some of the cases dealt with the taxation of individuals, such as case C-279/93 (*Schumacker*), case C-336/96 (*Gilly*), case C-391/97 (*Gschwind*) and case C-87/99 (*Zurstrassen*). Other cases dealt with the taxation of entities, such as case C-168/01 (*Bosal Holding*), case C-446/03 (*Marks & Spencer*), case C196/04 (*Cadbury Schweppes*), case C-446/04 (*Test Claimants in the FII Group Litigation*) and case C-298/05 (*Columbus Container*).

international agreements - and have concluded many bilateral conventions based, in particular, on the model conventions on income and wealth tax drawn up by the Organisation for Economic Cooperation and Development ('OECD')." [160] However, this can only be understood as an acceptance of the OECD methods of eliminating double taxation, but not more than that. It can by no means be seen as the "green light" for the application of CFC rules which, of course, is not only a matter of avoidance of double taxation but, in essence, a matter of attribution and taxation of foreign income derived through a separate taxpayer.

In the *Test Claimants in the FII Group Litigation* case the ECJ again dealt with the application of the credit method in the light of the TFEU. One of the questions referred for a preliminary ruling by the national court was the question whether it is contrary to Article 49 or Article 63 of the TFEU to keep in force and apply measures which exempt dividends received by a resident company from another resident company from corporation tax and which subject dividends received by a resident company from a company resident in another Member State to corporation tax.[161] Thus, it is essentially the question whether the application of the credit method on dividends from foreign companies results in a less favourable treatment compared to the application of the exemption method on dividends from domestic companies. In its response, the ECJ repeated what had already been stated in the *Keller Holding* decision: despite the possibility under Directive 90/435/EEC to apply, alternatively, the credit method or the exemption method the decision *"(…) may be exercised only in compliance with the fundamental provisions of the Treaty, in particular those relating to freedom of establishment.*"[162] Finally, the Court came to the conclusion that *"(…) in the case of the national legislation at issue in the main proceedings, the fact that nationally-sourced dividends are subject to an exemption system and foreign-sourced dividends are subject to an imputation system does not contravene the principle of freedom of establishment (…), provided that the tax rate applied to foreign-sourced dividends is not higher than the rate applied to nationally-sourced dividends and that the tax credit is at least equal to the amount paid in the Member State of the company making the distribution, up to the limit of the tax charged in the Member State of the company receiving the dividends*."[163] The outcome of this case is important since it opens the possibility for the Member States - under certain circumstances - to apply different methods for the avoidance of double taxation for cross-border dividends (credit method) and domestic dividends (exemption method). The aforementioned conclusion was, in principle, confirmed in the *Columbus Container* decision. Also in this case, the Court accepted that that the national legislation may choose between the two methods for the avoidance of double taxation of income derived through a PE, e.g. - like in this case - with a link to the tax rate in the PE state. However, such an approach requires that the taxation of the foreign PE income is not higher than the comparable taxation of domestic PE income. Thus, in both cases - *Columbus Container* and *Test Claimants in the FII Group Litigation* - the Court made it clear that the free choice of the state of residence to determine the method for the avoidance of double taxation requires that the amount of (dividend / PE) income is not subject to a tax disadvantage compared to a purely domestic situation.

[160] Case C-336/96 (*Gilly)*, paragraphs 23, 24.
[161] Case C-446/04 (*Test Claimants in the FII Group Litigation*), paragraph 31.
[162] Case C-446/04 (*Test Claimants in the FII Group Litigation*), paragraph 46; case C-471/04 (*Keller Holding*), paragraph 45.
[163] Case C-446/04 (*Test Claimants in the FII Group Litigation*), paragraph 57.

The acceptance of OECD principles in the jurisprudence of the ECJ is apparent, but this cannot be interpreted as a general compliance of the OECD model tax convention and the OECD principles with EU law.[164] However, the question arises whether the *Columbus Container* decision already provides the basis for a general and systematic piercing of the corporate veil. The reason is that the Belgian limited partnership in the *Columbus Container* case is a hybrid entity which is considered an entity under Belgian law, but a transparent partnership under German law. However, in *Columbus Container* the Belgian partnership was considered to be transparent because of an ‘analogy comparison’ (*Typenvergleich*). That means the foreign organisation form is compared to the domestic organisation form and, based on that comparison, the qualification is made. Hence, what is treated to be transparent in a domestic situation would also be treated to be transparent in a cross-border situation - without considering the qualification in the host state. This leads to a comparable treatment of investments from the perspective of the state of residence of the shareholder. If the state of residence considered all foreign entities to be transparent (in order to ensure the current taxation of income) this would result in a different treatment of foreign and domestic entities and would therefore not be in line with EU law. In contrast thereto, if the residence state (theoretically) focused only on the qualification in the host state (instead of an analogy comparison), this would by no means provide any (broad) basis for the current taxation of income. Instead, it would result in a rather unstructured concept of income allocation which, again, would treat foreign and domestic activities differently. Overall, it seems that the *Columbus Container* decision is not the key for a general and systematic current taxation of income.

The principle of world-wide taxation also played a role in the *Cadbury Schweppes* case. Here, the United Kingdom submitted that the legislation should be compared *only* to a United Kingdom resident company and, supported by other Member States, the legislation could not be considered discriminatory because the tax claimed from the company was no more than the total amount which would have been paid by that company and its subsidiaries if those subsidiaries had been established in the United Kingdom. The economic effect on Cadbury’s resources is thus the same in both cases.[165] According to those Member States, the CFC legislation pursues an objective of fiscal neutrality, by arranging for the overall tax burden on the economic unit consisting of a United Kingdom parent company and its subsidiaries to be identical, irrespective of whether the subsidiaries are established in the United Kingdom or in another Member State.[166] In response to this argument, Advocate General Léger stated that *“(t)he fact that the tax claimed from Cadbury would be no*

[164] See in this respect also the Opinion of the Advocate General to case C-324/00 (*Lankhorst-Hohorst*), paragraphs 80, 81. Advocate General Mischo pointed out that *“(…) the fact that the rules are consistent with the provisions of the OECD model convention does not also mean that they comply with Article 43 EC. Neither the provisions nor the objectives of the OECD model convention, on the one hand, or of the EC Treaty, on the other, are in fact the same. Admittedly, noting precludes an interpretation the EC Treaty, so far as possible, in accordance with an OECD model convention*.” In case C-128/08 (*Damseaux*), a case dealing with the double taxation of dividends in the state of source and the state of residence, the ECJ made it clear that *“(…) the Court does not have jurisdiction, under Article 234 EC, to rule on a possible infringement , by a contracting Member State, of provisions of bilateral conventions entered into by the Member States to eliminate or mitigate the negative effects of the coexistence of national regimes (…). Nor may the Court examine the relationship between a national measure and the provisions of a double tax convention (…) since that question does not fall within the scope of the interpretation of Community law*” (case C-128/08 (*Damseaux*), paragraph 22).

[165] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 68.

[166] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 69.

more than the total amount which would have been paid by the economic unit comprising the parent company and its subsidiaries if those subsidiaries had been established in the United Kingdom does not affect that analysis. The fact does not eliminate the unequal treatment at the level of the parent companies."[167] In its decision, the ECJ finally confirmed the position of the Advocate General and held that *"(e)ven taking into account (...) the fact (...) that such a resident company does not pay, on the profits of a CFC within the scope of application of that legislation, more tax than that which would have been payable on those profits if they had been made by a subsidiary established in the United Kingdom, the fact remains that under such legislation the resident company is taxed on profits of another legal person. That is not the case for a resident company with a subsidiary taxed in the United Kingdom or a subsidiary established outside that Member State which is not subject to a lower level of taxation.*"[168] Hence, the concept of fiscal neutrality - as put forward in this case - cannot be accepted as a justification for a restriction on the basic freedoms if it is applied in an inconsistent manner and therefore results in a different treatment - depending upon on the place of investment. Therefore, one of the important differences between *Cadbury Schweppes* and *Columbus Container* is the fact that in the latter case there is no different treatment of the income derived through a foreign PE and income derived through a domestic PE. In both situations, the income is directly attributed and taxed in the hands of the resident taxpayer (partner in the partnership). This is not true for the CFC legislation in *Cadbury Schweppes*: here, only the income of the CFC is attributed, but not the income of a comparable domestic entity.

8.2.5.9. Justifications and the Investment in Non-Member States

The question whether the aforementioned justifications have to be seen in a different light for CFC investments in non-member states is of importance for investments which are within the scope of the free movement of capital. It was outlined in chapter 4 that a differentiated approach towards third countries can, in principle, be required. The ECJ made this clear in a number of cases.[169] However, it is still necessary, also in case of investments in third countries, for the restrictive measure to be appropriate and proportionate.[170]

In the *Cadbury Schweppes* decision, the ECJ stated that *"(t)he resident company, which is best placed for that purpose, must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine.*"[171] And *"(i)n the light of the evidence furnished by the resident company, the competent national authorities have the opportunity, for the purposes of obtaining the necessary information on the CFC's real situation, of resorting to the procedures for collaboration and exchange of information between national tax administrations introduced by legal instruments such as those referred to by Ireland in its written*

---

[167] Opinion of the Advocate General Léger (case C-196/04 - *Cadbury Schweppes*), paragraph 76.
[168] Case C-196/04 (*Cadbury Schweppes*), paragraph 45.
[169] Case C-446/04 (*Test Claimants in the FII Group Litigation*), paragraph 171; case C-101/05 (*A*), paragraphs 36, 60 and 63; case C-540/07 (*Commission v Italy*), paragraph 69; case C-72/09 (*Rimbaud*), paragraphs 47 to 51. See in this regard also the Opinion of the Advocate General Cruz Villalón in the *Prunus* case (C-384/09), paragraphs 89 to 91. On May 5, 2011 the ECJ rendered its decision in the *Prunus* case. However, since the decision was based on the standstill clause of Article 64 (1) of the TFEU the ECJ did not analyse the question of a differentiated approach towards third countries / OCTs and the position of the Advocate General.
[170] Case C-101/05 (*A*), paragraph 56.
[171] Case C-196/04 (*Cadbury Schweppes*), paragraph 70.

observations, namely Council Directive 77/799/EEC (...) and, in this case, the Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Ireland for the avoidance of double taxation (...).”[172] Thus, if the CFC is established in a third country where an obligation exists to provide information in a manner similar to the obligations under Council Directive 77/799/EEC, e.g. on the basis of a double tax convention, one can certainly ask the question whether it is really necessary to have a different assessment of a possible justification for a restriction on the free movement of capital. In such a case, the resident taxpayer has, first, to provide proof that the CFC carries out genuine economic activities and that the structure is not merely a wholly artificial arrangement. If the taxpayer is not in a position to do so, the CFC rules shall be applicable. However, if the taxpayer can provide proof of a genuine economic activity and the tax authorities would like to gather, in addition, information from the state where the CFC is established, this can also be done on the basis of (bilateral) arrangements made between the two states. In the latter case, I do not see why a different assessment is required. In my opinion, the relevant factor should be that the other state has the obligation to provide the information which is actually needed for the decision whether the CFC rules have to be applied or not. The legal basis - directive and / or other (bilateral) arrangement - is, in my opinion, not decisive. On the other hand, if the state of residence of the shareholder in the CFC does not have any possibility of verifying the information of the taxpayer, e.g. in case of an investment in a tax haven where no arrangements for information exchange are existent, there is clearly a reason and a need for a differentiation. From my perspective, the allocation of the burden of proof to the taxpayer *combined* with the requirement of the existence of a legal basis for information exchange - and therefore the possibility of verifying the evidence provided by the taxpayer - ensures that genuine economic activities can be identified and separated from wholly artificial arrangements. Such an approach should comply with the principle of proportionality and the requirement that the least restrictive measures should be applied. This is, in any event, less restrictive than the general and undifferentiated application of CFC rules in case of third countries.

In my opinion, the above considerations are supported by the *A* decision. In this case, the ECJ made it clear that the Directive 77/799/EEC establishes a framework of cooperation which does not exist between the competent authorities of the Member States and the competent authorities of a third country where the latter has given no undertaking of mutual assistance.[173] According to the ECJ, it is therefore acceptable that the grant of a tax advantage is dependent on the possibility that the information submitted by the taxpayer can be verified by obtaining information from the competent authorities of the other country. If the third country is not under any contractual obligation to provide the relevant information, the tax advantage may be refused.[174] In the *A* case, the only information which could be obtained from the Swiss authorities was the information needed to ensure proper application of the double tax convention concluded between Sweden and Switzerland. However, neither the convention nor the protocol contained a measure providing for an exchange of information comparable to that in Article 26 of the OECD-MTC.[175] Therefore, the ECJ finally concluded that the respective Swedish measures which required, in case of a third country, a double tax convention providing for an

[172] Case C-196/04 (*Cadbury Schweppes*), paragraph 71.
[173] Case C-101/05 (*A*), paragraph 61.
[174] Case C-101/05 (*A*), paragraphs 62, 63.
[175] Case C-101/05 (*A*), paragraphs 54, 66.

exchange of information are justified by the need to guarantee the effectiveness of fiscal supervision and are proportionate to the aim pursued. The *Rimbaud* decision goes into the same direction. In this case, there was no obligation on the tax authorities of Liechtenstein to provide any assistance to the French authorities. So the latter authorities did not have any possibility to examine the correctness of the information provided by the taxpayer. Consequently, the ECJ did not recognise the submission of information by the taxpayer (case-by-case assessment) to be the less restrictive measure.[176] In his Opinion to the *Prunus* case, a case dealing with the relationship between France and the British Virgin Islands, the Advocate General comes to exactly the same conclusion.[177] Overall, it is apparent that Member States do not necessarily have to rely (only) on the evidence provided by the taxpayer, but may request that this information can be examined. However, I do not see that the legal basis - in order to examine the evidence provided by the taxpayer - has to be derived exclusively from EU measures, such as directives. If other contractual obligations provide for a comparable legal basis for gathering such information, the strict limitation to EU measures would not be, in my opinion, proportionate. It would take away, in general, the possibility of providing proof that a genuine economic activity is carried out in the third country. The *Commission v. Netherlands* case makes it clear that an argumentation which is based on the fact that Directive 77/799/EEC is not applicable in case of third countries (in this case Iceland and Norway) will not simply be accepted by the ECJ. The Court clearly recognised that the Dutch tax authorities must be in a position to verify compliance and, therefore, to gather information from the states involved. However, the respective legislation was not related to the conditions otherwise required in order to be entitled to the exemption from dividend taxation at source.[178] In my opinion, the ECJ (indirectly) accepts the fact that there can be an information exchange on a bilateral basis which deviates from the one existent within the EU on the basis of Council Directive 77/799/EEC but which may have the same effect. This was subsequently confirmed in the *Commission v. Italy* case.[179]

In essence, it can be concluded that CFC regimes may require the taxpayer to prove that the activity is a genuine economic activity *and* that a legal basis for information exchange between the competent tax authorities exists. The latter element of information exchange is always existent in case of an investment in another Member State (due to the fact that the Council Directive 77/799/EEC applies), but must be identified country-by-country if the investment is made outside of the EU.

8.2.5.10. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

As already outlined earlier, an alternative concept of current taxation of income should directly focus on the most critical element from an anti-avoidance perspective, namely the basic interest component. This is exactly the element in relation to which there is neither a justification from an economic perspective nor from an equity perspective for an exclusive taxation in the state of the intermediate (finance)

[176] Case C-72/09 (*Rimbaud)*, paragraphs 47 to 51. However, see the criticism of Gutmann in Lang et al., ECJ - Recent Developments in Direct Taxation 2010, Linde 2011, page 89 et seq. (97).
[177] Opinion of the Advocate General Cruz Villalón, paragraphs 89 to 91. The ECJ did not deal with this question since the decision was based on the standstill clause of Article 64 (1) of the TFEU.
[178] Case C-521/07 (*Commission v. Netherlands*), paragraphs 47 to 49.
[179] Case C-540/07 (*Commission v. Italy*), paragraph 70. See for further details section 4.2.10.4.

company. However, it was also concluded that, on the other hand, there is no justification for a current taxation of the other components, i.e. the risk component and the activity component. For this reason, there is a clear difference between the alternative concept and the CFC regimes which were outlined in chapter 6. The latter regimes focus - after a mere horizontal separation of income - on the current taxation of all income components. However, the decisive question is whether this difference is of any relevance for the ECJ, given the fact that - according to the case law of the ECJ - the legislation should have the specific purpose of preventing wholly artificial arrangements aimed at circumventing the domestic tax law. A legislation which is generally applied to a great number of situations which are not aimed at the circumvention of the domestic tax law cannot be justified on the basis of the aim of preventing tax avoidance. It is apparent, though, that the alternative concept does not (and should not) have the focus on wholly artificial arrangements but on income derived through genuine economic activities. This, and nothing else, should be the scope of the alternative legislation. For this reason, I do not see any realistic chance that the most obvious argument in a CFC case - which was rejected in the *Cadbury Schweppes* decision - would be accepted by the ECJ in the context of an alternative legislation which solely focuses on the current taxation of the basic interest component. Similar aspects are true for the other arguments outlined above which were (or which might be) put forward in a CFC case. The different treatment of the income components is most certainly not enough to provide a basis for a different assessment of the respective justifications under the TFEU as long as there is still the element of current taxation of income included. Of course, as a consequence, a system of current taxation of income - which is, in my opinion, undoubtedly required under the existing international legal framework - is to be applied in a non-discriminatory manner to income derived through resident and non-resident entities. In any event, I will come back to a “limited” capital export neutrality approach in some more detail below.

8.2.5.11. Conclusions Regarding the Justifications for Restrictions Caused by CFC Legislation

Based on the jurisprudence of the ECJ there can be a number of possible justifications under the rule of reason which are likely to come up in one way or another in cases dealing with CFC legislation. The following arguments for a justification of a restriction on the basic freedoms were examined in this context:

- the cohesion of the tax system;
- the loss of tax revenue and the erosion of the tax base;
- the lower taxation in the CFC country,
- the principle of territoriality;
- the protection of a balanced allocation of the power to impose taxes between Member States;
- the effectiveness of fiscal supervision;
- the aim of preventing tax avoidance;

- the principle of world-wide taxation.

In general, the examination shows that the above arguments cannot be accepted as a valid justification in a case dealing with CFC legislation. The argument which is based on the cohesion of the tax system, at least, lacks the required “direct link” between a tax advantage and a tax disadvantage. The arguments which are based on the loss of tax revenue and the erosion of the tax base as well as the lower taxation in the CFC country are not accepted by the ECJ, based on settled case law, because it finally comes down to a compensatory taxation. The principle of territoriality, the protection of a balanced allocation of the power to impose taxes between Member States as well as the effectiveness of fiscal supervision do not provide a sufficient basis for a possible justification, either. Given the fact that the CFC regimes are usually structured as an anti-avoidance (anti-deferral) legislation, the aim of preventing tax avoidance is certainly one of the most obvious arguments of justification. Nonetheless, the case law of the ECJ shows, in my opinion, that such legislation must focus on wholly artificial arrangements. From my perspective, this conclusion does not change due to the more recent decisions in *Part Service* and *Ampliscientifica*. The role of the tax motive is different in cases dealing with indirect taxation compared to cases dealing with direct taxation. In the first-mentioned cases, the national court has to make an overall assessment and has to decide whether the tax motive is essential compared to other non-tax explanations. In cases dealing with direct taxation, the motive for a relocation of activities to another state does not play a role as long as the company is genuinely established in the other state. Moreover, I do not think that the outcome of *Oy AA* has any impact on this conclusion, either. The fact that the ECJ accepted in *Oy AA* that the Finnish legislation was proportionate - even though it did not solely focus on wholly artificial arrangements - was, in my opinion, merely because of the fact that the restriction was justified by the much broader concept of a protection of a balanced allocation of power to impose taxes between Member States. In other words, there was no possibility of a strict limitation to wholly artificial arrangements, because the protection of a balanced allocation of power required a restriction of artificial and non-artificial arrangements.

However, the strict limitation to wholly artificial arrangements does not exist under the CFC regimes which were outlined in chapter 6 and which have not been amended after the *Cadbury Schweppes* decision (and according to this decision). These CFC regimes are applicable in an undifferentiated manner to different types of low-taxed income and are actually *intended* to be applicable to income generated by controlled foreign companies in another state through genuine economic activities. This is true for CFC regimes which follow an entity approach and for those which follow a transactional approach. Such concepts can hardly be brought in line with the requirement of focusing on wholly artificial arrangements. The fact that some of the regimes provide certain exemptions from CFC taxation is not sufficient. For this reason, the (theoretically) valid justification which is based on the aim of preventing tax avoidance will not be *proportional* as long as the CFC regimes do not provide the possibility to submit evidence that the activity carried out in the other state is a genuine economic activity - and to be exempt from CFC taxation in this situation. Finally, the principle of world-wide taxation must, after a more detailed analysis, also be rejected since the structure of CFC legislation does not consistently reflect the principle of capital export neutrality, but is merely an anti-avoidance concept.

With respect to investments in third countries, one may conclude that the taxpayer is required to prove that the activity is a genuine economic activity carried out in the respective state *and* that a legal basis for information exchange between the competent authorities exists. Of course, in contrast to an investment in another Member State - where the Council Directive 77/799/EEC is applicable - the latter requirement is not necessarily fulfilled in case of investments in third countries. However, the legal framework according to which the obligation for information exchange is stipulated between the respective countries should be secondary as long as the Member State of the shareholder has the legal possibility of gathering the necessary information. In other words, the obligation for information exchange can be based on a double tax convention and need not be derived exclusively from EU directives. This has the consequence that - with respect to possible justifications - a differentiation can be required between the investment in Member States and the investment in third countries. The latter is of particular relevance for investments in tax havens where no obligation for information exchange exists.

8.3. CFC Legislation and Secondary European Union Law

8.3.1. The Parent-Subsidiary Directive

It was outlined in chapter 4 that a deemed dividend should fall, in the same way as a regular dividend, within the scope of the Parent-Subsidiary Directive. With respect to the application of CFC rules and the scope of the Parent-Subsidiary Directive it is important to have a closer look at the amended version of the Directive which now also refers to transparent entities. The new paragraph 1 a states that *"(n)othing in this Directive shall prevent the State of the parent company from considering a subsidiary to be fiscally transparent on the basis of that State's assessment of the legal characteristics of that subsidiary arising from the law under which it is constituted and therefore from taxing the parent company on its share of the profits of its subsidiary as and when those profits arise. In this case the State of the parent company shall refrain from taxing the distributed profits of the subsidiary. When assessing the parent company's share of the profits of its subsidiary as they arise the State of the parent company shall either exempt those profits or authorise the parent company to deduct from the amount of tax due that fraction of the corporation tax related to the parent company's share of profits and paid by its subsidiary and any lower-tier subsidiary, subject to the condition that at each tier a company and its lower-tier subsidiary meet the requirements provided for in Articles 2 and 3, up to the limit of the amount of the corresponding tax due."*[180] In other words, the scope of the Directive is now much wider and also encompasses (i) the current taxation of income derived by a hybrid entity and (ii) stipulates an obligation for an exemption in the latter cases for subsequent (actual) distributions. Thus, there seems to be a clear separation between profit distributions of a subsidiary company, on the one hand, and income allocations which are related to hybrid entities, on the other hand. Theoretically, the question whether the application of CFC rules is within the scope of the Directive or not cannot be restricted to the CFC regimes which follow a deemed-dividend approach. It is very clear that it is equally relevant for those regimes which follow a piercing-the-veil approach. However, it seems to be obvious from the case law outlined in chapter 4 that it is not the domestic classification which is relevant for the question whether a CFC regime falls within the scope of the Directive, but that the

[180] Council Directive 2003/123/EC, dated December 22, 2003, new paragraph 1a.

domestic legislation must be seen in the context of the Directive and in the light of the intention of the Directive. Although the new paragraph 1 a does not explicitly deal with CFC taxation but only with hybrid entities, the situation after the amendment seems to be different from the situation before. I do not see any reason why the taxation of a hybrid entity should lead to an obligation to provide for an avoidance of double taxation under the Parent-Subsidiary Directive but not the current allocation of CFC income. According to Helminen, if the domestic concept was based on a fictitious distribution approach, the different treatment of regular and fictitious distributions would jeopardize the object and the purpose of the Directive and would conflict with the need of loyalty within the EU. With respect to Member States which do not follow a fictitious distribution approach, but an approach which is based on disregarding the foreign corporate entity, one should also conclude - especially after the amendment of the Directive regarding hybrid entities - that the income allocation is covered by the Directive. At least, this should be true as long as the CFC takes one of the forms listed in the Annex, is resident and subject to corporate tax in the host state without having the possibility of an option of being exempt from taxation.[181] In fact, a number of authors considered the Parent-Subsidiary Directive to be applicable in case of CFC legislation already before the amendment of the Directive.[182]

With respect to the Parent-Subsidiary Directive, the conclusion of the Advocate General Léger in the *Cadbury Schweppes* decision is quite interesting. In his Opinion to the case the Advocate General outlined that he does *"(...) not think that secondary legislation contains provisions relevant to this examination*" and *"(s)o far as concerns (...) the provisions of Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, they are not relevant in this case since they are designed solely to set up a common system as regards the taxation of profits distributed by a subsidiary. Those provisions do not relate to a system such as that provided for by the United Kingdom legislation on CFCs, which attributes to the parent company the profits of its foreign subsidiary as they arise.*"[183] This, without any doubt, is a clear statement against the application of the provisions of the Parent-Subsidiary Directive in CFC cases, at least according to the original version of the Directive. However, it is equally clear that this statement is only true regarding the classification of the income attribution as profit distributions. However, after the amendment to the Directive the scope of the latter is much wider. Of course, the concept of CFC taxation can neither be seen as a (fictitious) profit distribution by the subsidiary company nor can it be seen as the taxation of a hybrid entity (since most regimes typically consider the legal entity in question to be non-transparent). It is basically a system of taxing income on a current basis which is derived, at least in most cases, through the non-transparent subsidiary company. Pursuant to Maisto, the Directive should, in principle, cover deemed distributions of profit. However, the rules referring to hybrid entities apply to situations in which the transparency derives from the assessment of the legal characteristics of that subsidiary based on the law under which it is constituted. Hence, transparency which is derived from the application of CFC rules is basically

[181] Helminen, Is There a Future for CFC-Regimes in the EU?, Intertax 2005, page 117 et seq. (119).
[182] Scherer, Doppelbesteuerung und Europäisches Gemeinschaftsrecht, 1995, page 226; Helminen, The Dividend Concept in International Taxation, 1999, page 209; Helminen, Dividend Equivalent Benefits and the Concept of Profit Distribution of the EC Parent-Subsidiary Directive, EC Tax Review 2000, page 161 et seq. (164); FEE Position Paper, April 2002, page 15; Brokelind, Ten Years of Application of the Parent-Subsidiary Directive, EC Tax Review 2003, page 158 et seq. (163, 166).
[183] Opinion of the Advocate General Léger (case C-196/04), paragraphs 6 and 7.

not in the scope of the new paragraph.[184] Looking at the mere wording of the new paragraph, one might certainly come to such a conclusion. However, it would be neither logical nor consistent, after the amendment to the Directive, if the provisions of the Parent-Subsidiary Directive did not cover the application of CFC regimes. The reason is that those regimes can be seen as being in between the dividend taxation and the taxation of hybrid entities. The current attribution of CFC income requires (at least) the application of the credit method for the avoidance of double taxation - in the same way as the current allocation of income in case of a hybrid entity. Moreover, the distribution of profits of a subsidiary company to a parent company in another Member State - after the current income taxation according to a CFC regime - requires an exemption from the double taxation in the state of the parent company.[185]

Another point which might be raised in this context is the question whether the application of the CFC rules is covered by the 'anti-abuse' clause of Article 1 (2) of the Parent-Subsidiary Directive. Article 1 (2) states that the Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse. In this regard, it is important to note that this clause should have the purpose of avoiding that a taxpayer enjoys the advantages of the Directive merely by the establishment of an abusive structure, i.e. in situations where, under normal circumstances, the taxpayer would not be protected by the Directive.[186] However, if the CFC investment in another Member State is not just a wholly artificial arrangement, the *regular* profit distributions are, in principle, protected by the Directive. Why should the application of CFC rules - which merely creates an income allocation before the actual distribution takes place - result in a different treatment? Why should the tax credit be required in the first case but not in the second case? Such a differentiation cannot be derived from the fact that CFC rules can be seen - from the perspective of the Member States which apply such legislation - as anti-avoidance or anti-deferral measures. Helminen concluded that CFC regimes cannot be regarded as regimes which are covered by Article 1 (2) of the Parent-Subsidiary Directive, because without a CFC regime, there would not even be a distribution that would qualify for under the Directive.[187] Only if an abusive arrangement leads to the conclusion that the actual dividends may not fall within the Directive, the same should be true for fictitious dividends.[188] According to Brokelind, Article 1 (2) of the Directive has no existence of its own. Any refusal to grant a favourable tax regime must be supported by a specific proviso within the Directive, and this is not the case for CFC

[184] Maisto, The 2003 Amendments to the EC Parent-Subsidiary Directive: What's Next?, EC Tax Review 2004, page 164 et seq. (175).
[185] This should be equally true in a situation where the income is (indirectly) allocated through the revaluation of the shares in the CFC (e.g. like in the Netherlands) instead of a 'typical' CFC income attribution.
[186] See in this respect also Helminen, Is There a Future for CFC-Regimes in the EU?, Intertax 2005, page 117 et seq. (119); Helminen, Dividend Equivalent Benefits and the Concept of Profit Distribution of the EC Parent-Subsidiary Directive, EC Tax Review 2000, page 161 et seq. (164, 165); see with respect to the purpose of Article 1 (2) of the Directive also de Hosson, The Direct Investment Tax Initiatives of the European Community, Kluwer, 1990, pages 426, 427; Eilers, Gemeinschaftsrechtliche Anwendungsrestriktionen für § 42 AO, Der Betrieb 1993, page 1158; Weber, A Closer Look at the General Anti-Abuse Clause in the Parent-Subsidiary Directive and the Merger Directive, EC Tax Review 1996, page 63 et seq.
[187] Helminen, Is There a Future for CFC-Regimes in the EU?, Intertax 2005, page 117 et seq. (119); Helminen, Dividend Equivalent Benefits and the Concept of Profit Distribution of the EC Parent-Subsidiary Directive, EC Tax Review 2000, page 161 et seq. (165); see in this respect also de Hosson, The Direct Investment Tax Initiatives of the European Community, 1990, page 427.
[188] Helminen, Is There a Future for CFC-Regimes in the EU?, Intertax 2005, page 117 et seq. (119).

rules.[189] Moreover, Brokelind takes the position that Member States are only able to use such an 'anti-abuse' clause to prevent the most serious cases of abuse, leaving aside the tax avoidance cases.[190] Overall, the 'anti-abuse' clause of Article 1 (2) of the Parent-Subsidiary Directive does not have the effect, in my opinion, that the current allocation of income according to CFC regimes is excluded from the protection of the Directive.

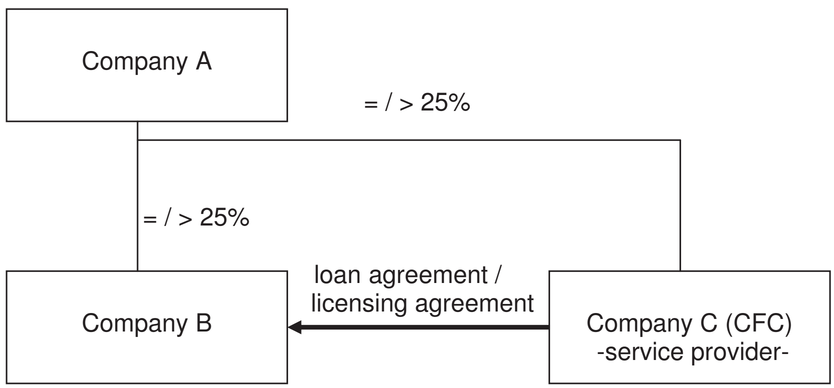
However, the impact of the Parent-Subsidiary Directive should not be overestimated: the avoidance of double taxation related to the attributed income by the provision of an ordinary tax credit as well as the subsequent exemption is already offered by almost all CFC regimes (alternatively the subsequent credit of the previous income taxes, as in the case of the United Kingdom). For this reason, the obligations which are established by the Parent-Subsidiary Directive should not result, at least in most cases, to amendments to the respective CFC regimes. Nonetheless, the Directive becomes an additional limitation for changing the structure of CFC regimes.

8.3.2. The Interest and Royalty Directive

The Interest and Royalty Directive[191] is of no relevance, in my opinion, for the attributable CFC income, because the latter income is - leaving aside the classification of the attributable income - not subject to withholding taxation.[192] The reason is that the current attribution of income is based on unilateral measures of the Member State of primary establishment without any actual payments (distributions) of the foreign company. The (subsequent) payments, however, are dividend payments which are within the scope of the Parent-Subsidiary Directive - if the requirements are fulfilled - but which are not in the scope of the Interest and Royalty Directive. Despite this conclusion, however, the latter Directive may still be of importance in the context of CFC taxation. The reason is very simple: if the Interest and Royalty Directive provides for an exemption from withholding taxation, this takes away the possibility for Member States of applying a (limited) taxation at source. This, however, can support low-tax states and certain structures which are usually in the focus of CFC taxation. This may be illustrated by the following example:

[189] Brokelind, Ten Years of Application of the Parent-Subsidiary Directive, EC Tax Review 2003, page 158 et seq. (162).
[190] Brokelind, Ten Years of Application of the Parent-Subsidiary Directive, EC Tax Review 2003, page 158 et seq. (159).
[191] Council Directive 2003/49/EC, dated June 3, 2003.
[192] However, it is questionable what might be seen as a withholding taxation. With respect to the inclusion of half of the interest expenses paid to non-resident companies in the tax base for purposes of German trade income taxation see: Kessler / Eicker / Schindler, Hinzurechnung von Dauerschuldzinsen nach § 8 Nr. 1 GewStG verstößt gegen die Zins- / Lizenzgebühren-Richtlinie, Internationales Steuerrecht 2004, page 678 et seq.; Kempf / Straubinger, Nochmals: Die EU-Zins- / Lizenzrichtlinie und § 8 Nr. 1 GewStG, Internationales Steuerrecht 2005, page 773 et seq.; Meilicke, Die Hinzurechnung von Dauerschuldzinsen nach § 8 Nr. 1 GewStG, Internationales Steuerrecht 2006, page 130.

Figure 7:



The structure in the example is one of the structures which are covered by the Interest and Royalty Directive. Article 3 (b) of the Interest and Royalty Directive states that "*a company is an "associated company" of a second company if, at least: (i) the first company has a direct minimum holding of 25% in the capital of the second company, or (ii) the second company has a direct minimum holding of 25% in the capital of the first company, or (iii) a third company has a direct minimum holding of 25% both in the capital of the first company and in the capital of the second company. Holdings must involve only companies resident in Community territory. However, Member States shall have the option of replacing the criterion of a minimum holding in the capital with that of a minimum holding of voting rights*." Thus, the interest and royalty payments from company B to company C (sister company) should be exempt from withholding taxation in Member State B if parent company A holds a minimum participation of 25 percent in company B and in company C. If it is assumed that the withholding tax rate in Member State B for interest and royalty payments to Member State C is 5 percent, e.g. according to the double tax convention between these two states, and if it is further assumed that Member State C is a low-tax state with an income tax rate of 10 percent, it is quite obvious that the position of Member State C is considerably improved. In effect, the non-deduction of withholding tax in Member State B increases the net income tax imposed in Member State C from 5 percent to 10 percent, because no tax credit is necessary anymore. If the taxable income of such intra-group service companies is an important factor for the economy of Member State C, the latter Member State could even consider a reduction of the overall corporate income tax rate in order to attract additional service companies. Indirectly, this would be financed by the fact that no withholding tax is deducted in Member State B and therefore no crediting of such taxes is required anymore. Of course, a CFC taxation in state A would eliminate any potential advantage which might be caused by the non-deduction of withholding tax in state B and a theoretical reduction of the corporate income taxation in state C. However, the picture is different if the existing CFC rules cannot be applied anymore - due to the fact that they are not in line with the freedom of establishment and / or the free movement of capital - and therefore any reduction of the income tax rate in state C becomes a real advantage for the group of companies - to the detriment of states A and B. Without any doubt, the abolition of withholding taxation may in certain situations lead to administrative advantages for the taxpayer and can avoid the double taxation of income. However, the aforementioned example shows that it can create situations which underline that an alternative approach to CFC legislation is still required.

Similar to the Parent-Subsidiary Directive, the question can be raised whether the 'anti-abuse' clause of Article 5 of the Interest and Royalty Directive may be of relevance in this context. Article 5 states that "*(t)his Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse*"[193] and "*Member States may, in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraw the benefits of this Directive or refuse to apply this Directive.*"[194] In the structure outlined above it is (again) assumed that company C is the beneficial owner of the income received. There is no artificial relocation of activities and income to state C and therefore no abusive (and no fraudulent) arrangement.[195] Similar to Article 1 (2) of the Parent-Subsidiary Directive, Article 5 of the Interest and Royalty Directive should protect the Member States from the effect of 'directive shopping'.[196] In the latter case, the Member States should have the possibility of refusing the advantages conferred by the Directive. However, I do not see - under the assumptions described above - that Article 5 of the Interest and Royalty Directive can have a direct or indirect impact on the application of CFC rules in state A. This is, in my opinion, outside of the scope of the Directive.

8.3.3. The Outcome of the Examination Tested to the Principles Derived from Previous Chapters

The Parent-Subsidiary Directive and the Interest and Royalty Directive are both of relevance for an alternative system which is based on the current taxation of the basic interest component. In case of the Parent-Subsidiary Directive, it can be concluded, in my opinion, that this Directive is generally applicable in case of a current taxation of income derived through a CFC and it should not really matter how the legislation is structured in detail, i.e. whether it is a "typical" CFC legislation, a concept which is based on the revaluation of shares or an alternative legislation which follows the current taxation of the basic interest component. In my opinion, there is no basis to come to a different conclusion for the alternative concept since in both cases it is the attribution of (all or part of) the income realised through a subsidiary company. Furthermore, this has the consequence that an alternative legislation has to provide for the elimination of double taxation for the currently attributed income and has to exempt the income which was already taxed in the state of the shareholder in case of a subsequent profit distribution. This means for the basic interest taxation that the latter system should, at least, provide for an ordinary tax credit (because an exemption would not make any sense under such an approach) and the subsequent - actual - distribution of the part of the income which is related to the basic interest component has to be exempt from taxation.

[193] Article 5 (1) of the Interest and Royalty Directive.
[194] Article 5 (2) of the Interest and Royalty Directive.
[195] See with respect to the differentiation between 'tax evasion' and 'tax avoidance' Müller, The Interest & Royalty Directive, Tax Planning International European Union Focus (June) 2005.
[196] See with respect to 'directive shopping' also Brokelind, Royalty Payments: Unresolved Issues in the Interest and Royalties Directive, European Taxation 2004, page 252 et seq. (256).

In addition, the conclusion with respect to the Interest and Royalty Directive clearly supports an efficient and target-oriented anti-avoidance legislation which focuses on the basic interest component. The reason is that the Interest and Royalty Directive safeguards (also) the critical structures which involve intermediate (finance) companies by providing exemption from withholding taxation for interest and royalty payments to the latter companies. This leads to the result that there is a complete switch from a limited source-based taxation of the basic interest component to a non-taxation of the basic interest component in the state of source. This is self-evidently not the outcome which is supported by economic and equity principles which theoretically request the taxation according to the principle of capital import neutrality in the state where the income was produced. Although the limited taxation in the state of source is not the optimal scenario, either, it is nonetheless an approach which goes in the right direction. For this reason, the Interest and Royalty Directive has negative “side effects” which can make the relocation of the basic interest component - and therefore the most critical element from an anti-avoidance perspective - more attractive. In this respect, there is an increased necessity for an alternative anti-avoidance legislation which is in line with primary and secondary EU law.

8.3.4. Conclusions Regarding the Parent-Subsidiary Directive and the Interest and Royalty Directive

The examination shows that secondary EU law does not play an equally important role for the application of CFC regimes as primary EU law. Nonetheless, the CFC regimes may still be influenced by secondary EU law. Firstly, the concept of CFC regimes can be directly within the scope of a Directive. For example, the Parent-Subsidiary Directive is, in my opinion, also relevant for the application of CFC regimes. The reason is that the amended version of the Directive not only covers profit distributions but also the current taxation of income derived through a hybrid entity. In my opinion, the current taxation of income according to CFC regimes is somewhere “in between” these two concepts. Clearly, the current taxation of income according to CFC regimes can neither be seen as the taxation of a profit distribution nor as a taxation of income derived through a hybrid entity. However, it would be neither logical nor consistent, in my opinion, to consider the income attribution which is related to a non-transparent entity to be outside of the scope of the Parent-Subsidiary Directive under these circumstances - and I do not think that this was the intention. Moreover, it is not possible, in my opinion, to disallow the application of the Parent-Subsidiary Directive to CFC income attributions on the basis of Article 1 (2) of the Directive, either. The latter clause should have the purpose of avoiding that a taxpayer enjoys the advantages of the Parent-Subsidiary Directive merely by the establishment of an abusive structure, i.e. in situations where, under normal circumstances, the taxpayer would not be protected by the Directive. This, however, is usually not an issue in case of CFC investments. Overall, the most important consequence of such a conclusion is the requirement - based on the Parent-Subsidiary Directive - to provide the elimination of double taxation either by an exemption of the attributed income or by the provision of an ordinary tax credit and to grant an exemption from income taxation for profit distributions which were already subject to current taxation in case of a hybrid entity. In general, this is already granted by almost all of the existing CFC regimes and it does not seem that, in this respect, the requirements in the Directive go beyond what is already provided under those regimes. However, the Directive becomes an additional limitation for changing the structure of CFC regimes.

Secondly, there can be an indirect influence on CFC regimes through secondary EU law. The latter is true, for example, in case of the Interest and Royalty Directive. The examination shows that the abolition of withholding taxation in certain situations clearly supports the structures which are typically in the focus of CFC regimes. The ‘anti-abuse’ clause of Article 5 of the Interest and Royalty Directive does not have, in my opinion, any effect on the CFC structures, because there is typically no artificial relocation of activities and income which might be qualified as abusive or fraudulent arrangement. The non-existence of a withholding tax credit (due to the fact that there is no withholding tax) on the level of an intermediate finance company may considerably improve the situation of the country where the intermediate finance company is established. Moreover, the abolition of a withholding taxation in the country where the income is produced is, despite all administrative simplifications, contrary to the economic and equity principles derived from chapters 2 and 3. The concept of the Interest and Royalty Directive may therefore result in the fostering of group structures which include intermediate finance companies by granting “withholding tax incentives.” In my opinion, this is one of the reasons - together with the conclusions from previous chapters - why there is still a need for an alternative legislation as a replacement for the existing CFC regimes. The examination shows that the conclusions with respect to CFC legislation and the Parent-Subsidiary Directive / the Interest and Royalty Directive can be easily transferred to an alternative legislation which focuses on the current taxation of the basic interest component.

8.4. The Dilemma of the Member States

The dilemma of the Member States which apply a CFC regime is apparent: either they provide for an “escape clause” for genuine economic activities which are carried on in the other state or the CFC legislation will not be in line with the freedom of establishment (alternatively - depending on the situation - the free movement of capital). One could now start thinking about possible approaches with a number of standardised exemptions from CFC taxation (as in case of the United Kingdom CFC legislation which was examined in the *Cadbury Schweppes* case) *and* an additional escape clause for the taxpayer. However, I do not think that this would really solve the problem. The reason is very simple: the Member States which apply CFC legislation *want* to tax the income which is derived by the CFC from a genuine activity in the other state. This is exactly the income which is in the focus of CFC taxation! As already outlined earlier, the criteria which were put forward by the Advocate General in the *Cadbury Schweppes* case are those which are sometimes used for the identification of abusive structures under national legislation - but not CFC legislation. However, those abusive structures do not usually trigger the application of CFC rules but lead to other tax consequences. For example, wholly artificial arrangements such as the interposition of “letterbox companies” often have the consequence that the income is directly allocable to the domestic shareholder and the interposition of the legal entity is “ignored” for tax purposes. That means the income is deemed to be derived directly by the shareholder. If this is the case, the CFC regime does not play any role since the income is already taxed in the state of the shareholder based on another anti-abuse measure. Another important case is the “decision making” in the Member State of the shareholder: if the CFC is actually managed from within the

Member State of the shareholder, it usually results in the taxation of the non-resident company in the latter Member State. Such a decision is based on the fact that the effective place of management is most often the decisive element for the question which state has the right to tax the income of the legal entity. Moreover, and in addition to these cases, it is important to note that transfer pricing rules play a supporting role, too. Services without economic value might already be subject to transfer pricing adjustments - in the cases in which the CFC itself is, in general, accepted by the domestic legislation of the Member State which applies the CFC rules. However, the aforementioned aspects are, at the same time, relevant criteria in the EU case law for a differentiation between wholly artificial arrangements and non-artificial arrangements. Thus, by separating the abusive structures - under national legislation - from those which are subject to CFC taxation, the Member States clearly show that they have the intention to currently tax income from genuine economic activities. The latter income can neither be considered to be abusively shifted to a non-resident entity in a low-tax country nor can it be corrected according to transfer pricing principles. Of course, in most cases the Member States do not, in principle, classify the whole income as income which is currently attributable to the domestic shareholder, but this is not the point.[197] The important aspect is that the ECJ clarified that the income which is typically marked as CFC income by the Member States is not necessarily linked to wholly artificial arrangements. Thus, if the CFC derives income from a genuine economic activity in another state and the taxpayer is able to provide the proof for such an activity, there is no possibility for the Member States of taxing this income on a current basis if they do not extend, at the same time, the legislation in an undifferentiated manner to situations which are currently outside of the CFC regimes, i.e. to income derived by domestic companies and to income derived by companies in other states which currently do not trigger the CFC taxation. In other words, the problem lies in the fact that the escape clause would essentially result in an exemption of income from CFC taxation which is obviously seen, by the Member States which apply those rules, as “the main target” of CFC regimes. For this reason, I doubt that the implementation of an escape clause is an appropriate solution for a great number of Member States.

In principle, it is understandable that Member States with a comparably high tax rate want to protect their tax revenues and want to stop the erosion of the domestic tax base in favour of low-tax countries. Some of the smaller Member States offer lower tax rates which attract, in particular, capital investments which are usually classified as “passive” investments. A situation like in the *Cadbury Schweppes* case not only leads to the result that the interest income from the financing activities which is related to third countries is not taxable in the United Kingdom, but also leads to the result that the domestic tax base is reduced by interest paid to the CFC. Thus, especially the mobile activities can be re-located very easily from one state to another state.[198] It is obvious that the re-location of such mobile activities is, in particular, attracted by lower tax rates and the tax rate differences between the high-tax states and the low-tax states.[199] The situation is particularly difficult if the scope is

[197] Even though the entity approach may result in a complete allocation of income (which encompasses the active and passive income).

[198] See with respect to mobile activities: Harmful Tax Competition - An Emerging Global Issue, OECD, 1998, and the subsequent Progress Reports. See for more details section 5.10.

[199] See with respect to competitiveness and mobility also The NFTC Foreign Income Project: International Tax Policy for the 21st Century, Report and Analysis, prepared by the US National Foreign Trade Council, December 15, 2001; Sandler, Tax Treaties and Controlled Foreign Company Legislation, Pushing the Boundaries, 1998, pages 1, 2.

widened to countries outside of the EU. Here, it is simply impossible for high-tax Member States to compete with all types of low-tax regimes offered all around the globe.[200] In principle, I fully support tax competition, but it must be clearly differentiated between sound competition among states which leads to an efficient allocation of resources (and therefore also capital) and harmful competition which is triggered by those countries and territories which have an over-proportional advantage from the inflow of capital and mobile investments to the detriment of other states. Without any doubt, there should not be any kind of “race to the bottom” if it is not clearly supported by economic principles.[201] However, since it is, in practice, very difficult to find a border line between sound and harmful competition, I consider it necessary that Member States should have the possibility to apply legislation which focuses on the taxation of income related to mobile investments.[202] Such legislation, however, should be in line not only with the economic and equity principles outlined in previous chapters, but also, of course, with the basic freedoms and the jurisprudence of the ECJ. Thus, it seems that an approach which focuses on the taxation of the basic interest component of capital for certain mobile investments - without making a differentiation based on the place of investment - could be a very efficient approach which fulfils the aforementioned requirements and which does not, at the same time, restrict sound competition.

8.5. The Reaction of Member States to Comply With European Union Law

In the following, I will outline some of the amendments to national legislation and (legislative) proposals which were made in order to comply with EU law - especially after the *Cadbury Schweppes* decision.

8.5.1. Finland

With effect from January 1, 2009 the Finnish CFC legislation was amended in order to be in line with EU law. The new section 2a of the Finnish CFC regime makes it clear that the regime shall not apply to an entity resident in an EEA state or a tax treaty state whose tax system does not differ substantially from the Finnish tax system, provided that an exchange of information is possible with the other state. The latter information exchange may be based on a bilateral agreement concluded between Finland and the other state. In addition, the exclusion from CFC taxation requires that the entity is actually established and that a genuine economic activity is carried on in the other state. Currently - and if the latter requirement of a genuine economic activity is fulfilled - the exclusion applies to all EEA state except Liechtenstein and to all tax treaty states except those whose tax system differs substantially from the Finnish system. This is the case if the corporate tax in the other state is on average less than 75 percent of the corresponding Finnish tax determined according to the Finnish tax rules (which is now expressly stipulated in the CFC

[200] See the features of harmful preferential tax regimes in Harmful Tax Competition - An Emerging Global Issue, OECD, 1998, page 26 et seq.
[201] See section 2.4. regarding the underlying economic principles.
[202] See in this regard also the conclusions from the OECD-Report on Harmful Tax Competition and the EU Code of Conduct for business taxation which is outlined in section 5.10.

regime).[203] The tax treaty states which differ substantially from Finland's tax system are included in a list which shall be up-dated from time to time.[204]

In order to identify whether the foreign entity is actually established in the other state and carries on genuine economic activities the following factors shall be considered:

1.) the company has the premises and equipment which are necessary for its activities available for its own use in its residence state;

2.) the company has sufficient personnel available for its own use in its residence state and the personnel has the power to independently carry on the business of the company; and

3.) the personnel independently makes the decisions concerning the daily activities of the company.[205]

However, the evaluation has to be made on the basis of all objective factors that are ascertainable by third parties. In principle, with the revised CFC legislation Finland follows the *Cadbury Schweppes* decision. Moreover, the necessity of an information exchange clause in a tax treaty is in line with previous conclusions regarding the CFC investment in third countries and the case law of the ECJ, e.g. the *A* case. However, I do not see why it is necessary to maintain a link to the tax rate in a third country. If a tax treaty is established between Finland and the other state which provides for an exchange of information, I do not think that it is required to stipulate, in addition, a minimum threshold for the corporate tax rate in the CFC state.

The revised legislation is now also applicable to permanent establishments, i.e. foreign permanent establishments and foreign legal entities can both be in the focus of the Finnish CFC regime. In addition, the participation requirement has been increased to 25 percent shareholding in the CFC. A Finnish resident taxpayer may now be taxed on CFC income only if he has at least a shareholding of 25 percent in the CFC. Further changes are related to the type of income under domestic law, the elimination of double taxation and the tax loss carry forward limitation. The latter limitation was extended from five years to ten years and now complies with the general limitation under the Finnish Income Tax Act.[206]

8.5.2. France

The French CFC legislation already provides for an "EU entity exemption" to a shareholding in the foreign entity which does not constitute a wholly artificial arrangement intended to escape French tax normally payable. According to the guidelines to the French legislation, published in 2007, the notion of "wholly artificial arrangement" must be assessed with regard to the objective criteria arising out of the

[203] The Finnish corporate tax rate in 2009 is 26 percent. The threshold is therefore 19.50 percent (26 percent x 0.75).
[204] The list which was published in June 2009 includes Barbados, Bosnia-Herzegovina, Georgia, Macedonia, Malaysia, Moldavia, Montenegro, Serbia, Singapore, Switzerland, the United Arab Emirates and Uzbekistan (see IWB Kurznachrichten, Internationale Wirtschafts-Briefe 2009, Fach 1, page 1420).
[205] Helminen, Amendments to Finland's CFC Regime, Bulletin for International Taxation 2009, page 163 et seq. (164).
[206] Helminen, Amendments to Finland's CFC Regime, Bulletin for International Taxation 2009, page 163 et seq. (165).

jurisprudence of the ECJ, especially in accordance with the *ICI* decision and the *Cadbury Schweppes* decision. Hence, if it can be proven that, despite any tax motives, the CFC is actually established in another Member State, the French CFC rules shall not be applicable.[207] Thus, it seems that the criteria which were derived from the jurisprudence of the ECJ in cases dealing with direct taxation were considered, but not the conclusions from VAT cases.[208] As already outlined earlier, this is, in my opinion, an appropriate approach. It has to be noted, though, that the aforementioned concept applies to participations held by French corporations, but not by French individual shareholders. It is therefore obvious that the legislation does not, in the latter case, comply with EU law.[209] It is worth mentioning that the French CFC rules were supplemented - with effect as of 2010 - by rules which target investments in non-cooperative jurisdictions.[210] Under these rules, dividends, interest, royalties and payments for services made to entities located in a non-cooperative jurisdiction will be subject to a 50 percent withholding tax. Moreover, dividends received from entities in such jurisdictions do not benefit from the French participation exemption regime.[211]

8.5.3. Germany

The German tax authorities issued an Administrative Circular in January 2007 which clarifies the impact of this decision on the German CFC rules.[212] It is not really surprising to me that the tax authorities did not see the necessity to refrain, in general, from the application of the German CFC rules, but made it clear that the provisions of the German Foreign Income Tax Act are, in principle, still applicable. The CFC rules are no longer applied to income derived by companies in EU / EEA states if the latter companies carry on a genuine economic activity in the respective states. However, this is not true for states which do not provide appropriate procedures for collaboration and exchange of information. However, in order to be exempt from CFC taxation on the basis of the carrying on of a genuine economic activity, the taxpayer has to provide evidence that

a.) the company participates - in the state where the company is established or where the company has its place of management - in the course of its ordinary business on an active, permanent and lasting basis in the local market;

b.) the company employs the management and other personnel in the host state on a permanent basis;

c.) the personnel of the company must be qualified to carry out the functions assigned to the company in their own responsibility and independently;

---

207 Malherbe et al., Controlled Foreign Corporations in the EU After *Cadbury Schweppes*, Tax Management International Journal 2007, page 607 et seq.; see in this respect also Taylor / Sykes, Controlled Foreign Companies and Foreign Profits, British Tax Review 2007, page 609 et seq. (644, 645).

208 It has to be noted, though, that the cases C-425/06 (*Part Service*) and C-162/07 (*Ampliscientifica*) were only decided in the year 2008.

209 See in this respect Lovells' International Tax Team, Impact of Cadbury Schweppes on CFC Legislation, 2007.

210 A black list is now published annually by the French tax authorities.

211 Deloitte, Controlled Foreign Company Regimes Essentials, 2011, country report France; see also Franche - Concept of "Non-Cooperative Jurisdiction" Added to Anti-Tax Haven Rules, KPMG Tax News Flash-Europe, no. 2010-04, January 21, 2010.

212 Administrative Circular, January 8, 2007 (IV B 4 - S 1351 - 1/07).

d.) the income is created through the company's own activities;

e.) if the services are provided to related parties, they must result in an additional economic value for the recipient of the services and the employment of capital for the services must be in an appropriate relation to the economic value which is created by the services.

Apparently, the tax authorities refer - to a certain extent - to the test suggested by the Advocate General in the *Cadbury Schweppes* case.[213] However, it has to be noted that (i) the Court did not explicitly refer to the (complete) test but rather focused on the physical presence in the host Member State and that (ii) the German requirements go too far and do not correspond to the conclusions of the ECJ: the decision neither requires that the activity is related to the local market (see letter a) nor any appropriate relation of the employment of capital to the economic value created by the services of the CFC (see letter e). Another important point is the fact that the German rules considerably restricted the test by not accepting the provision of evidence - and therefore the possibility of being exempt from CFC taxation in case of a genuine economic activity - in the following situations:

- The income was subject to CFC taxation *only* because of section 7 (6) of the German Foreign Income Tax Act. This means that income from capital investment was subject to CFC taxation (without the possibility of providing the aforementioned evidence) if the participation of German resident taxpayers was up to 50 percent. If the participation exceeded 50 percent, the general rule applied and the provision of evidence was possible.

- The income was derived through a company which is established outside of the EU / EEA.

- The income was derived through a permanent establishment outside of the EU / EEA.

In German tax literature the question was raised whether the first-mentioned exception resulted in a *general* exclusion from the possibility of providing evidence of a genuine economic activity for income from capital investment.[214] However, this would have had the consequence that the Circular would not be in line with the *Cadbury Schweppes* decision, because it was exactly this type of income which was in the focus of the latter decision. However, it seems that the references and the word 'only' makes it clear that the exception is limited to income from capital investments where the participation of German residents in the CFC is up to 50 percent.[215] In other words, if the CFC derives income from capital investment and the German residents hold a participation which does not exceed 50 percent, there is no possibility of providing evidence for a genuine economic activity. This would affect, in

[213] See in this respect also Rainer / Müller, Remarks to the German Administrative Circular, Internationales Steuerrecht 2007, page 151 et seq. (152).
[214] Köplin / Sedemund, Das BMF-Schreiben vom 8.1.2007 - untauglich, die EG-Rechtswidrigkeit der deutschen Hinzurechnungsbesteuerung nach *Cadbury Schweppes* zu beseitigen!, Betriebs-Berater 2007, page 244 et seq. (247).
[215] See in this regard also Schönfeld in Flick / Wassermeyer / Baumhoff, Außensteuerrecht, Kommentar, Vor §§ 7-14, paragraph 312; Haun / Käshammer / Reiser, Das BMF-Schreiben vom 8.1.2007 zur Hinzurechnungsbesteuerung - eine erste Analyse, GmbH-Rundschau 2007, page 184 et seq. (187).

any event, participations which are within the scope of the free movement of capital, but may also effect non-majority participations which might still be within the scope of the freedom of establishment, e.g. in case of substantial shareholdings[216] Thus, the German focus on a majority holding of resident taxpayers (whether they are related parties or not), does not necessarily comply with the jurisprudence of the ECJ.[217] For example, this can result in a situation where a German resident with a 50 percent participation in a CFC does not have the possibility of providing evidence of a genuine economic activity (because there are no additional German resident shareholders), but a participation of 5 percent provides the latter possibility, because the CFC is dominated by German (unrelated) shareholders - and therefore the general rule applies. In essence, the German approach outlined in the Administrative Circular seems to be inconsistent and not fully in line with the requirements determined by the ECJ.

With effect of January 1, 2008, the German Foreign Income Tax Act was amended in order to consider the outcome of the *Cadbury Schweppes* decision.[218] The legislative amendment now provides the possibility for an exemption from CFC taxation if the taxpayer can provide evidence that the CFC carries out a genuine economic activity in the host Member State. The limitation to EU/EEA States as well as the necessity of appropriate procedures for collaboration and exchange of information reflects, in essence, what was already stated in the Administrative Circular. However, in contrast to the Administrative Circular, no further details are included in the amended legislation which specify the requirements and which provide guidance with respect to the term “genuine economic activity.” It is therefore not unlikely that the elements which are outlined in the Administrative Circular are still considered valid criteria from the perspective of the tax authorities for the separation between genuine economic activities and wholly artificial arrangements.[219] Insofar, the criticism outlined above remains and the legislative changes would not result in any improvement with respect to the question of compatibility with EU law. However, the clear restriction with respect to income from capital investment - which was explicitly stated in the Administrative Circular - is not as clear anymore in the amended legislation. Instead, it is now stated that only income which is derived through the activity of the CFC itself can be allocated to the genuine economic activity and only to the extent that the arm’s length principle was taken into account. It seems that the legislator tries to have a “back door” for the application of the CFC rules to income from capital investments.[220] At least, the preparatory work shows that it is intended to make a separation of the activities instead of accepting that a certain economic activity - within the foreign entity - leads to the result that the total income is exempt from CFC taxation. For example, if the personnel of the CFC provides a number of group services (which can be seen as a genuine economic activity carried on in the respective state) and, in addition, financial means are ‘routed’ through the CFC, but

[216] See, for example, the *SGI* case in which a shareholding of 34 percent was sufficient to come within the scope of the freedom of establishment (case C-311/08 (*SGI*), paragraphs 34, 35).
[217] See in this regard also Köhler / Eicker, Kritische Anmerkungen zum BMF-Schreiben „*Cadbury Schweppes*“ v. 8.1.2007, Deutsches Steuerrecht 2007, page 331 et seq. (332).
[218] Section 8 (2) of the German Foreign Income Tax Act (*Außensteuergesetz).*
[219] The intention was, however, to replace the Administrative Circular by the legislative changes. This is clearly stated in the Circular itself.
[220] However, see in this respect the position of Goebel / Palm who concluded that the revised legislation might be seen, at least from the ‘mere wording’, as a motive test which can be in line with the requirements determined by the ECJ in the *Cadbury Schweppes* decision (see Goebel / Palm, Der Motivtest - Rettungsanker der deutschen Hinzurechnungsbesteuerung?, Internationales Steuerrecht 2007, page 720 et seq. (726).

the decisions which are necessary in the latter context are made by the parent company, this should still result in the CFC taxation of the interest income (but not in the CFC taxation of the service income).

8.5.4. Italy

The Italian CFC legislation applies not only to "black-listed" jurisdictions but also to "non-black-listed" jurisdictions if the effective tax rate imposed on the CFC is at least 50 percent lower than the tax rate the CFC would have been subject to in a comparable domestic situation and if certain passive and intra-group service income exceeds 50 percent of the income of the CFC. The rules for entities in "non-black listed" jurisdictions do not apply if the resident taxpayer obtains a ruling of the Italian tax authorities which states that the CFC does not constitute an artificial structure aimed at receiving an improper tax benefit.[221]

In case of "black-listed" jurisdictions it is important to note that the exemption in case of an "effective business activity" now also requires the activity to be mainly carried out in the respective market of establishment.[222] Thus, the Italian legislation, in essence, provides some sort of exemption from CFC taxation for business activities. However, it has to be kept in mind that the exemption is completely dependent on the ruling of the tax authorities and one can certainly argue that such a procedure may still represent an excessive burden - compared to domestic investments and investments in other states. Moreover, it is still open to which extent the concept of an "effective business activity" from the perspective of the Italian tax authorities complies with the differentiation provided by the ECJ in the *Cadbury Schweppes* decision.[223] At least, a ruling which was described in an article of Bardini shows that the interpretation of the Italian tax authorities does not necessarily comply with the earlier conclusions in this chapter. In the latter ruling, the exemption from CFC taxation could not be obtained since the CFC, established in Switzerland, sold products which were neither produced in Switzerland nor sold on the Swiss market. Thus, the fact that the CFC did not do business in the market of establishment resulted in the conclusion of the Italian tax authorities that there was no sufficient interpenetration of the CFC in the territory of establishment. According to the Italian tax authorities, such a requirement can be directly inferred from the *Cadbury Schweppes* decision.[224] Overall, the Italian tax authorities request a direct link of the business activity *to the market* of establishment. As already outlined earlier, such a requirement cannot, in my opinion, be inferred from the case law of the ECJ at all.

[221] See Scarioni / Muni, The New Italian CFC Rules: EU Holding Companies Challenge the 'Artificial Arrangement' Assessment, Intertax 2010, page 527 et seq.; Mayr, Auswirkungen der aktuellen Steueränderungen - Neuerungen im italienischen Steuerrecht 2010, Internationale Wirtschafts-Briefe 2010, page 131 et seq.; Mayr, Maßnahmen des italienischen Gesetzgebers - Die Entwicklungen des italienischen Außensteuerrechts 2010, Internationale Wirtschafts-Briefe 2010, page 670 et seq. (679).
[222] Mayr, Maßnahmen des italienischen Gesetzgebers - Die Entwicklungen des italienischen Außensteuerrechts 2010, Internationale Wirtschafts-Briefe 2010, page 670 et seq. (679).
[223] See in this respect Lovells' International Tax Team, Impact of Cadbury Schweppes on CFC Legislation, Tax Planning International Review 2007.
[224] See Bardini, The Fine Line between Anti-Abuse Measures and the Delimitation of a Member State's Tax Jurisdiction: The Italian Case, European Taxation 2010, page 374 et seq. (377). Essentially, Bardini comes to the conclusion that the new Italian CFC rules are not in full compliance with established EU principles.

8.5.5. The United Kingdom

The United Kingdom, which is directly affected by the *Cadbury Schweppes* decision, responded very soon with a proposal for changes of the CFC legislation. The approach included in the Draft Finance Bill 2007 follows a completely different and innovative route which comes, in general, closer to the proposals which can be derived from chapters 2 and 3, i.e. a separation of the income components instead of a mere separation according to the type of income. However, similar to the German approach, the United Kingdom proposed legislative changes deviating, in my opinion, from the conclusions which can be derived from the *Cadbury Schweppes* decision. The HMRC Draft Guidance on the Changes to Controlled Foreign Companies Rules[225] outlines that "*the ECJ decided that CFC rules pursue a legitimate aim and are compatible with European law - so long as they are not applied to the profits of genuine economic activities undertaken in an actual establishment in another Member State*."[226] And "*the Government is satisfied that the UK's CFC legislation is compatible with European law as interpreted by the ECJ in Cadbury Schweppes. But the Government recognises that there may be circumstances at the margins where it may not be entirely clear*."[227] Theoretically, it would have been obvious - after the *Cadbury Schweppes* decision - to simply clarify the "motive test" or, if necessary, change it to a test which grants an exemption from CFC taxation in case of genuine economic activities, i.e. to provide the possibility for the taxpayer of proving that the CFC carries on a genuine economic activity. Instead, it was decided to retain the system of current taxation and to provide for the deduction of a "specific amount" from the total amount of attributed income which reflects the "net economic value" created by the personnel of the CFC. The "net economic value" is defined as *"the real economic profit to the group as a whole created directly by the work of individuals working for the CFC in an EEA state, after allowing the full economic costs to the group of carrying out the work*."[228] The HMRC Draft Guidance explains that *"(...) the distinction within a CFC is, in essence, between profits, that arise from labour and those that arise from capital. Profits from labour tend to be created where the activities are located. Profits from capital are mobile and have no automatic link with where the activities take place and can be (and often are) diverted elsewhere. For the purposes of the new rules, therefore, in respect of profits not already exempt because one of the existing exemptions in the rules applies, the profits identified as arising form "genuine economic activities" are those created by the labour of the individuals working for the CFC in its EEA business establishment(s). Profits from capital will rarely, for these purposes, constitute profits from "genuine economic activities." Further, activities that are entirely intra-group and, of themselves add no value to the group (e.g. intra-group lending) cannot give rise to profits of "genuine economic activities." By definition, they simply move value from one part of the group to another*."[229] It is stated further that *"(t)he value of the work must be assessed in relation to its actual content and the competence and level of independence/authority of the person carrying out the work. For example, works that has minimal content and*

[225] HMRC Draft Guidance, December 6, 2006, Changes to Controlled Foreign Companies Rules (can be found under www.hmrc.gov.uk/pbr2006/controlled-foreign-companies.pdf.). See also Schönfeld, Reaktion der britischen Regierung auf "Cadbury Schweppes": Geplante Änderungen der britischen CFC-Rules und deren Vereinbarkeit mit EG-rechtlichen Vorgaben, Internationales Steuerrecht 2007, page 199 et seq.; Taylor / Sykes, Controlled Foreign Companies and Foreign Profits, British Tax Review 2007, page 609 et seq.
[226] HMRC Draft Guidance, paragraph 4.
[227] HMRC Draft Guidance, paragraph 6.
[228] HMRC Draft Guidance, paragraph 21.
[229] HMRC Draft Guidance, paragraphs 17 to 19.

nominally (or notionally) relates to capital or assets placed artificially in the CFC may have some intrinsic value; however this value will be limited and very marginal when compared to the value of the profits that arise form the capital or assets. In such circumstances, the profits in the CFC largely come from the diversion of profits to it, rather than those profits being created by its work. Such diversion of profits may be achieved, for example, by placing capital or other assets, such as intangible assets, in the CFC; or by arranging capital to accumulate in a CFC, or ownership of new intellectual property to arise in a CFC. Such profits do not constitute "net economic value" to the group created directly by the work of the staff in the CFC. A useful guide is that the "net economic value" should equate to what the group would be prepared to pay to a third party to undertake the work done by staff working for the CFC in the relevant state(s), over and above the full economic costs of undertaking the work."[230] The HMRC Draft Guidance also contains examples to clarify the respective approach. Here, it is outlined that, in the first example, the profits realised by operating a call centre in a CFC state may result in a complete deduction from the chargeable profits. The work of the call centre employees is considered to directly create value for the group by contributing to the delivery of its business.[231] In the second example, the CFC is equipped with equity and passes the funds on to other group companies, on the directions of the UK parent, in the form of interest-bearing loans. The CFC rents an office and pays two employees of a group company in the same Member State to carry out the necessary administration. In this example, the income from the loans is no net economic value to the group as a whole. The loans simply transfer value from one part of the group to another. Even if there were any value, it would be - according to the Draft Guidance - attributable solely to the location of capital in the CFC and not to any work done by staff of the CFC. Thus, a deduction is not to be granted.[232] In the third example, the CFC employs a small team of staff to undertake work involved in the administering of intellectual property - which was placed in the CFC - and receiving royalties. Pursuant to the Draft Guidance, little of the income from the intellectual property can be considered to constitute net economic value created directly by the individuals working for the CFC in the other state. This is because the real economic value arises not from the administrative work carried out by the CFC's staff but from the legal ownership of the intellectual property by the CFC. In this case, a deduction may only be granted to the extent which reflects an arm's length net return for the administrative work undertaken in the CFC.[233]

Again, the concept can be seen as innovative and it goes into a similar direction as the basic interest approach. However, the limitation of the deduction to the net economic value - as defined in the Draft Guidance - is not, in my opinion, sufficient from an economic and equity point of view. Here, I will not repeat what was outlined in earlier chapters, but it is obvious that the concept overlooks the fact that the capital provided may create income in a *third* country (e.g. if the funds are provided to another group company outside the CFC state and outside the United Kingdom). In this case, the income should be subject to income taxation where the income is produced, but this is neither the United Kingdom nor the CFC state. However, if this is not the case - because of the fact that the interest income is not subject to a source-based taxation - the income will be, first of all, taxed in the CFC state. The

[230] HMRC Draft Guidance, paragraphs 23, 24.
[231] HMRC Draft Guidance, annex 1, example 1.
[232] HMRC Draft Guidance, annex 1, example 2.
[233] HMRC Draft Guidance, annex 1, example 3.

latter state also takes the direct risk related to, for example, an interest-bearing loan. If this is the case, a symmetrical approach requires the income taxation of the risk elements in the CFC state (and not, in addition, in the United Kingdom - because the CFC regime does not take into account - directly - the negative income which might be created through the taking over of the risks). Furthermore, it is important to recognise that such a concept is not in line with the *Cadbury Schweppes* decision.[234] Based on the latter decision, the CFC regime should not be applied in case of genuine economic activities. Thus, if the carrying on of an activity can be classified as such a genuine economic activity, the complete activity should be exempt from CFC taxation. The activity cannot be separated into income from capital and income from labour work - as long as it is not done in a non-discriminatory manner. However, this is exactly the point: the concept is still limited to low-taxed non-resident companies and is not applicable to domestic companies. The revised CFC regime would, therefore, still lead to a CFC taxation of all or almost all of the income derived from an activity which was subject to verification in the *Cadbury Schweppes* case.[235]

In June 2007 the United Kingdom tax authorities issued a consultative document with the title “Taxation of the Foreign Profits of Companies: A Discussion Document.”[236] The document contains, amongst others, fundamental changes to the United Kingdom CFC rules. Interestingly, the discussion document considerably deviates from the aforementioned described concept included in the HMRC Draft Guidance of December 2006. In fact, what the tax authorities now propose is not only a switch from an entity approach to a transactional approach regime, but also the broadening of the scope of the legislation to companies resident in the United Kingdom.[237] The latter, of course, is a major step towards a CFC regime (which shall then be called “CC regime”) which might be in line with the basic freedoms of the TFEU. The tainted income is - according to the discussion document - separated as follows:

- Passive (or investment) income. This income encompasses dividends, interest, annuities (and other purchased income streams), royalties, rents, and other income of similar nature.[238] “Participation dividends” are exempt from CC taxation.[239]

[234] See in this respect also Schönfeld, Reaktion der britischen Regierung auf „Cadbury Schweppes“: Geplante Änderungen der britischen CFC-Rules und deren Vereinbarkeit mit EG-rechtlichen Vorgaben, Internationales Steuerrecht 2007, page 199 et seq.

[235] It has to be noted that on 17 December 2007 a revised version of the Draft Guidance was published and superseded the original guidance. The Revised Draft Guidance sets out further detail on the “effectively managed” condition of the “exempt activity test” as well as expands on the distinction drawn in the original guidance between profits created in another Member State and those profits merely “diverted” to another Member State from elsewhere. The Revised Draft Guidance also contains additional examples. The document is still called ‘Draft Guidance’. See with respect to the Revised Draft Guidance also Persoff, HMRC Revised Draft Guidance on Controlled Foreign Companies Rules, EC Tax Review 2008, page 96.

[236] Taxation of the Foreign Profits of Companies: A Discussion Document, June 2007, HM Treasury / HM Revenue & Customs. The document can be found on the Treasury website at: http://www.hm-treasury.gov.uk.

[237] Discussion document, paragraph 4.7 et seq. See with respect to the proposal also Evans / Delahunty, E.U. Perspective on U.K. CFC Rules, Tax Planning International Review 2007 ; Malherbe et al., Controlled Foreign Corporations in the EU after *Cadbury Schweppes*, Tax Management International Journal 2007, page 607 et seq. ; Taylor / Sykes, Controlled Foreign Companies and Foreign Profits, British Tax Review 2007, page 609 et seq. ; Deuchar / Steel, UK Throws Out Controlled Foreign Companies Regime, International Tax Review 2008, page 41 et seq.

[238] Discussion document, paragraphs 4.20 - 4.22.

[239] Discussion document, paragraph 4.27.

- Other mobile income. The latter encompasses sales income from deliveries to or from the UK or from affiliates where the goods are not delivered into the CFC's territory of residence; and intra-group / UK-derived sales or service income from "wholesale, distributive, financial or service" businesses.[240]

Exemptions from the attribution of passive income are provided for income from genuine active finance business (banking, financial, insurance activity and property investment businesses) and certain intra-group interest.[241] The exemption for intra-group interest applies to interest from other affiliates provided that it was paid out of profits not covered by the CC rules and the receiving company was appropriately capitalised and, for example, does not have more equity than would be expected for a typical intra-group lender.[242] Further exemptions shall be provided for certain specified income from intra-group transactions within the same country, for identical income (to exempt from charge passive income that was incidental to a subsidiary's main trade) and for conduit income (to exempt passive income that was received in a fiduciary capacity for financing that does not involve the avoidance of UK withholding tax).[243]

It is proposed that the regime shall be applicable in case of participations of at least 10 percent and it is planned, therefore, to "*modernise the definition of control*."[244] However, it is planned to exclude smaller businesses from the CC regime (or, alternatively, to have a more limited application in case of smaller businesses).[245] The attributable income shall be calculated on the basis of UK GAAP.[246] It is important to note, though, that it is apparently the tainted income which is attributed to the shareholder without any deduction of a "specific amount" which reflects the "net economic value" (as originally described in the HMRC Draft Guidance). The latter is, in my opinion, a step backwards from a concept which reflects economic necessity, because the legislation which is now proposed in the discussion document can be seen as a typical transactional approach regime. On the other hand, the application of the system to resident and non-resident participations is a substantial - and necessary - improvement. I have already outlined earlier that there seems to be no option to a non-discriminatory approach for CFC type legislation. A decision with respect to the compatibility with EU law can only be made on the basis of a more concrete concept. However, looking at the different elements, it might be critical to provide an exemption for certain specified income from intra-group transactions within the same country. Essentially, this might result - in case of a UK based multinational company - in a great number of exemptions from CC taxation within the UK, but results in a CC taxation for income derived through a foreign service centre

[240] Discussion document, paragraphs 4.28 - 4.30.
[241] Discussion document, paragraphs 4.23 - 4.24.
[242] Discussion document, paragraph 4.25.
[243] Discussion document, paragraph 4.26.
[244] Discussion document, paragraph 4.16. A 10 percent threshold for a "controlling influence" does not necessarily correspond to what is to be understood as a "definite influence" under Article 49 of the TFEU. For example, the general threshold in the German legislation which was in the focus in *Lasertec* required a "substantial holding" which was a holding of more than 25 percent (case C-492/04 (*Lasertec*), paragraph 21). See 4.2.7.1 for more details.
[245] Discussion document, paragraph 1.9 and Annex C. Smaller businesses are those with fewer than 50 employees and whose turnover or balance sheet does not exceed 10 million euro.
[246] Discussion document, paragraph 4.31.

which provides services exclusively to group companies in other countries (including the UK).[247]

In the Finance Bill 2009 the 'foreign profits package' was introduced after a long period of consultation, but contains rather minor changes to the United Kingdom CFC legislation.[248] The exemption from apportionment for profits of a foreign company that qualifies as a holding company under the exempt activities test was removed. The same was true for the exemption based on an 'acceptable distribution policy.' It is important to note that - in addition to the amendments to the CFC legislation - the new legislation also treats foreign and UK distributions in the same way. Distributions will be exempt if they fall into an exempt class and if anti-avoidance provisions do not apply. Further amendments with respect to the CFC regime are included in the Finance Bill 2011. A new exemption for foreign-to-foreign intra-group trading activities shall be introduced. In order to qualify for the exemption under the latter rule, the following conditions have to be satisfied:[249]

- the CFC must have a business establishment in its territory of residence;

- the CFC's business must not include substantial non-exempt activities;

- the CFC must not have a significant connection with the UK; and

- the CFC must not have more than 5 percent gross income arising from financing or intellectual property.

Moreover, an additional exemption is included for CFCs with a main business of intellectual property exploitation if the intellectual property and the CFC have minimal business connection with the UK. Further amendments are, *inter alia*, related to the *de minimis* exemption (increase in the threshold) and the extension of transitional rules for superior and non-local holding companies.[250]

In June 2011 the UK Treasury published a consultation paper which includes detailed proposals for how the new CFC regime will operate.[251] The general idea of the new concept is the protection against artificial diversion of profits from the UK to low tax jurisdictions, with a focus on monetary assets and intellectual property.[252] Profits arising from genuine economic activities and profits where there is no artificial diversion of UK profits shall not be taxed. Under the proposed concept, a CFC is a company that is (i) under UK control, (ii) is resident outside the UK and (iii) has profits which are taxed at a lower effective rate than if it were resident in the UK.[253] The definition of "UK control" should determine that a foreign company is treated as

[247] At least, this is the conclusion for CFC type legislation on the basis of the examinations in chapters 4 and 8.
[248] See the Budget 2009 (and related information) which was published on April 22, 2009. This can be found on the HM Revenue & Customs website at www.hmrc.gov.uk.
[249] See the overview in E&Y International Tax Services, International Tax Update: Finance Bill 2011, December 2010; Deloitte, Controlled Foreign Company Regimes Essentials, 2011, country report UK; see also the HM Treasury / HM Revenue & Customs report "CFC Interim Improvements" which can be found on the HM Revenue & Customs website at www.hmrc.gov.uk.
[250] see the HM Treasury / HM Revenue & Customs report "CFC Interim Improvements."
[251] HM Treasury / HM Revenue & Customs, Consultation on Controlled Foreign Companies (CFC) Reform, June 30, 2011. The intention is that the new rules will be introduced in Finance Act 2012.
[252] Consultation paper, page 6.
[253] Consultation paper, page 12.

controlled by the person or persons that control the economic rights over the assets or income of the company, whether through the ability to direct the affairs of the company or otherwise. In this regard, three alternatives are presented in the consultation paper: a principles-based approach, an accounting standards approach and a more mechanical approach.[254] The definition of "resident outside the UK" will follow the generally established residence principles and the "lower effective tax rate" will be determined on the basis of a 75 percent threshold. That means it is intended to maintain the low level of tax test according to which the foreign company is low-taxed if the actual tax paid is less than 75 percent of the amount which would have been paid if the foreign company were resident in the UK.[255] The proposed exemptions from CFC taxation are the following:[256]

a.) Low profits exemption

The consultation paper presents a number of options for an exemption of CFCs which are facing a relatively low profit. The options include a general threshold with a limit on investment income,[257] a variable threshold which depends on the size of the group,[258] and a general threshold without any additional limitations for certain types of income and irrespective of the size of the group.[259] In addition, the *de minimis* exemption for CFCs with chargeable profits of up to 50,000 British Pounds may be retained.[260]

b.) Excluded countries exemption

The idea of the excluded countries exemption is to provide a proxy for the lower level of tax test by exempting CFCs that are located in jurisdictions with tax regimes that have broadly similar rates and bases to the UK.[261] The consultation paper does not specify which countries will be included in such a "white list."

c.) Temporary period exemption

The intention is to provide a temporary period exemption for entities that are brought within the CFC rules as a result of a commercial acquisition or certain group reorganisation. The proposal is an exemption for up to three years for potential CFCs which come under UK control as a result of the aforementioned transactions.[262]

d.) Territorial business exemptions

The territorial business exemptions are proposed to be separated as follows: (i) an exemption based on the CFC passing a profits rate safe harbour (a margin of 10 percent or less on its operating expenses), (ii) an exemption for a CFC carrying on a

[254] Consultation paper, pages 15, 16.
[255] Consultation paper, pages 16, 17.
[256] There is no requirement to apply the exemptions in a specific order and a CFC may qualify for more than one of the exemptions (see consultation paper, page 12).
[257] The amount proposed is 500,000 British Pounds (general threshold) and capping investment income at 50,000 British Pounds or 10 percent of the total income.
[258] A range between 200,000 British Pounds and 1,000,000 British Pounds is proposed.
[259] The amount proposed is 200,000 British Pounds.
[260] Consultation paper, pages 19, 20.
[261] Consultation paper, pages 20-22.
[262] Consultation paper, page 22.

manufacturing trade, and (iii) a more general exemption for a CFC carrying on commercial activities. The latter exemption would cover (1.) trading and certain business activities between a CFC and other foreign companies (whether or not connected), (2.) trading and certain business activities between a CFC and UK persons (whether or not connected), where there is no arrangement in place to artificially divert profit from the UK, (3.) trading activities relating to the exploitation of foreign IP which does not pose a significant risk to the UK tax base. A CFC which is engaged to a substantial extent ("around 20 percent") in investment activities would not be able to benefit from the exemption. In each case the CFC would need to meet a local management condition. Incidental finance income that arises from the working capital of that business will be exempt. Also in this case, a number of different options are outlined.[263] IP income will be exempt if it is related to the holding and exploitation of foreign IP which has not been transferred from the UK, nor has significant economic connection with the UK. Moreover, the exemption will also be available for local IP that is integral to a genuine overseas manufacturing trade and for royalty income that is incidental / ancillary to the trade.[264]

e.) Finance company rules

The finance company rules include a *partial* exemption for certain overseas financing activities. Essentially, this will result in an effective UK tax rate of 1/4 of the regular UK rate on profits from overseas intra-group finance income. Different design options are presented and the annex includes a number of illustrative examples in order to understand the mechanism. The CFC would need to meet a local management condition.[265]

f.) General purpose exemption

The general purpose exemption fulfils, in principle, the role of the motive test in the current UK CFC rules and can be applied in order to exempt profits that have not been artificially diverted from the UK. This exemption will consider the facts and circumstances to assess whether any profits have been artificially diverted. There will be no default assumption that profits received by a CFC would have arisen in the UK if the CFC did not exist. In those cases where profits have been artificially diverted to a CFC, only the profits that have been diverted from the UK to avoid tax will be subject to an apportionment. Profits arising from genuine foreign to foreign business activity will be exempt.[266]

g.) Sector specific rules

The consultation paper includes sector specific exemption rules for insurers and banks.[267]

Looking at the concept outlined in the consultation paper, it seems that - despite the substantial number of changes within the regime - this is merely an amendment to

[263] Consultation paper, pages 25-32.
[264] Consultation paper, pages 49-53.
[265] Consultation paper, pages 33-40 and pages 75-82 (annex D).
[266] Consultation paper, pages 41-47.
[267] Consultation paper, pages 65-69 (insurance exemption, annex B) and pages 71-74 (banking exemption, annex C).

the "CFC type" rules but not the introduction of an innovative system, for example on the basis of the HMRC Draft Guidance published in 2006. Even though new elements are included, one might still get the impression that there was no real intention to deviate too much from the general principles of the usual CFC type elements. I share the view of Hardwick and Bouwer who stated that "*given the similarities between these proposals and the existing CFC regime, one may be forgiven for questioning whether a wholesale reform of the rules is really needed*."[268] Clearly, what has to be achieved by the reform is the compliance with EU law and, in this regard, the consultation paper comes to the conclusion that this is the case.[269] In my view, the above exemptions a.) - e.) and g.) are not sufficient to restrict the application to wholly artificial arrangements. The key might be the general purpose exemption (f.) which does not include a default assumption and only focuses on profits that - according to the understanding of the UK Treasury - have been artificially diverted to a CFC. However, it is more than questionable whether this really leads to a limitation to wholly artificial arrangements. In other words, the question is whether the concept does not, again, also (partially) target genuine economic activities which only in the eyes of the UK Treasury are to be seen as wholly artificial arrangements. In my opinion, it is not unlikely that the latter will happen and there are a number of commentators who have similar concerns.[270]

8.5.6. Denmark

The revised Danish approach focuses on a widening of the regime to tainted income derived through *resident and non-resident companies* without any link to the effective tax rate or tax burden.[271] In other words, the Danish approach treats domestic and foreign tainted income "equally disadvantageous" - compared to non-tainted income - by taxing such income on a current basis. In addition, the Danish CFC regime applies to an ownership of *more than 50 percent* and only to subsidiaries which derive *more than 50 percent* financial income. Further, the regime applies if more than 10 percent of the subsidiary's assets are "financial assets." It is likely, in my opinion, that the ECJ will accept such an approach - due to the fact that the CFC regime is equally applicable to tainted income derived by resident and non-resident subsidiaries. I do not think that the ECJ will take into account the fact that such an approach will often result in an increase of the tax rate for income produced in the CFC country which theoretically requires - from an economic and equity perspective - a source based taxation. It seems to me that such a compromise "weakens" the regime from an anti-avoidance perspective without gaining anything from an economic and equity perspective. Further, such an approach does (still) not reflect properly the idea and the concept of an internal market. I will come back to the latter aspect below.

[268] Hardwick / Bouwer, Plus Ca Change…? Full Reform of the Controlled Foreign Company Rules, Linklaters UK Tax Alert, July 1, 2011.
[269] Consultation paper, pages 97-99 (annex I).
[270] See in this regard Hardwick / Bouwer, Plus Ca Change…? Full Reform of the Controlled Foreign Company Rules, Linklaters UK Tax Alert, July 1, 2011, page 3; Controlled Foreign Companies Proposals may not be EU Compliant, Experts Warn, Tax Journal, July 5, 2011.
[271] The changes are part of the Danish "Spring Tax Package" of April 2, 2007. See in this respect also Schönfeld, Dänemark: Ausdehnung der Hinzurechnungsbesteuerung auf das Inland?, Internationales Steuerrecht 2007, Länderbericht, pages 1, 2; Wittendorf, Tax Notes International 2007, pages 537, 538.

8.5.7. Sweden

With effect of January 1, 2008 the Swedish CFC legislation was amended by introducing a new provision which states that the owner of a CFC is excluded from CFC taxation if the foreign legal entity "constitutes an actual establishment from which activities conducted for business reasons are carried out."[272] This shall be true for establishments within the EEA. According to the new provision, the following three factors should be taken into consideration for the latter assessment:

1.) whether, in its home state, the foreign legal entity has premises and equipment to the extent necessary for conducting the business;

2.) whether, in its home state, the foreign legal entity has staff with the degree of competence necessary for independently conducting the business; and

3.) whether the staff is free to independently make decisions in matters relevant to the ongoing business.[273]

It is important to note that all relevant circumstances have to be considered and, therefore, the examination is not limited to the aforementioned factors. That means the fact that an establishment lacks one (or even more) of the factors does not automatically lead to a CFC taxation if the taxpayer is in a position to provide (other) evidence of an actual establishment from which activities conducted for business reasons are carried out. Furthermore, even though the phrase "activities conducted for business reasons" does not necessarily comply with the terminology of the ECJ in *Cadbury Schweppes*, the preparatory work to the new provision stressed that the wording of the Swedish legislation must not be interpreted as more far-reaching than what is allowed by *Cadbury Schweppes*.[274] Hence, the Swedish approach seems to follow closely the lines of the ECJ in the *Cadbury Schweppes* case. Of course, such measures will most certainly result in a CFC legislation which is in line with EU law. However, this will not result, as already outlined above, in an optimal structure from an anti-avoidance perspective, an economic perspective, an equity perspective and an internal market perspective.

[272] See with respect to the revised Swedish CFC legislation: Pihlgren, New Proposed CFC Legislation, International Tax Review 2007; Mutén, Schweden: Hinzurechnung, DBA mit Marokko, USA und "Nordisches" zur Erbschaftsteuer, und Alkoholversand, Internationales Steuerrecht 2007, Länderbericht, page 4; Sundgren, Swedish CFC Taxation and the 'Business Purpose' Concept, Tax Notes International 2008, page 133 et seq. Barenfeld, Sweden's New CFC Regime after *Cadbury Schweppes* - Comments and Analysis, Bulletin for International Taxation 2008, page 295 et seq. (296).

[273] See Barenfeld, Sweden's New CFC Regime after *Cadbury Schweppes* - Comments and Analysis, Bulletin for International Taxation 2008, page 295 et seq. (297).

[274] According to Barenfeld, the straightforward statement in the preparatory work clearly indicates that the rule, despite the questionable wording, must be interpreted based on the narrow concept of "wholly artificial arrangements" as defined by the ECJ (see Barenfeld, Sweden's New CFC Regime after *Cadbury Schweppes* - Comments and Analysis, Bulletin for International Taxation 2008, page 295 et seq. (297)). It is worth noting that the Swedish Tax Agency issued a proposal for an amendment to the CFC legislation which is, *inter alia*, related to the application of the rules to low-taxed income from the leasing of patents, licenses, trademarks and similar rights as well as to the change of the white list. However, the proposed amendments do not affect companies which are actually established within the EEA and are conducting activities motivated by business reasons (see E&Y International Tax Alert, Swedish Tax Agency Proposes Amendments to CFC Legislation, May 7, 2010; KPMG Tax News Flash-Europe, Sweden: Proposal to Change the CFC Rules, Would Impose Additional Restrictions Concerning "the White List", no. 2010-24, May 19, 2010).

8.6. Limitation to European Union and European Economic Area States?

It is interesting to see that the additional exemptions in the revised CFC regimes are usually granted in case of investments in EU Member States and EEA States, but they are sometimes not granted to the same extent in case of investments in third countries. According to the Finnish, German and United Kingdom CFC rules, it is required - in case of EEA States - that these States offer appropriate procedures for collaboration and the exchange of information between national tax administrations.[275] In practice, this means that the additional exemptions are applicable to EU Member States and the EEA States Iceland and Norway, but apparently not to investments in Liechtenstein.[276] In this regard, it is worth noting that the EEA Treaty contains freedoms which are, in substance, identical to the freedoms of the Treaties. This, at least, was clarified by the EFTA Court in the *Focus Bank* decision[277] and by the ECJ in the *Ospelt und Schlössle Weissenberg* decision.[278] Thus, it is in principle consistent to treat the (additional) EEA States in the same way as EU Member States with respect to a possible exemption from CFC taxation. However, it was concluded in section 8.2.5.9. that the Member States which apply CFC rules can request that the taxpayer proves that the activity is a genuine economic activity *and* that a legal basis for information exchange between the competent tax authorities exists. For this reason, it does not really make a difference whether an EEA State or a third state is 'uncooperative' and does not provide a basis for information exchange. In both cases the information exchange can be requested as a valid criterion to provide an exemption from CFC taxation.[279]

8.7. The Council Resolution on Coordination of the CFC Rules within the European Union

In June 2010 the Council of the European Union published a Resolution on the coordination of CFC and thin capitalisation rules within the EU.[280] In essence, what is recommended in this Resolution is that Member States adopt some guiding principles with respect to the application of CFC and thin capitalisation rules. For CFC rules, the Resolution presents a non-exhaustive list of indicators which suggest that profits are artificially diverted to a CFC. The indicators listed in the Resolution are the following:[281]

[275] See with respect to Germany the Administrative Circular, January 8, 2007 (IV B 4 - S 1351 - 1/07) and the revised section 8 (2) AStG. See with respect to the United Kingdom the HMRC Draft Guidance, paragraphs 30, 31.
[276] See HMRC Draft Guidance, paragraph 31; Schönfeld, Reaktion der britischen Regierung auf "Cadbury Schweppes": Geplante Änderungen der britischen CFC-Rules und deren Vereinbarkeit mit EG-rechtlichen Vorgaben, Internationales Steuerrecht 2007, page 199 et seq. (200); Rainer / Müller, Remarks to the German Administrative Circular, Internationales Steuerrecht 2007, page 151.
[277] Case E-1/04 (*Fokus Bank ASA*), Internationales Steuerrecht 2005, page 55 et seq., paragraph 23.
[278] Case C-452/01 (*Ospelt und Schlössle Weissenberg*), paragraph 29.
[279] See with respect to the necessity of an information exchange between the states involved case C-521/07 (*Commission v. Netherlands*), paragraphs 47 to 49, case C-72/09 (*Rimbaud*), paragraphs 47 to 51 and the Opinion of the Advocate General Cruz Villalón to case C-384/09 (*Prunus*), paragraphs 89 to 91. See also 8.2.5.9. for further details.
[280] Council Resolution of 8 June 2010 on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union. The Council Resolution was published in the Official Journal of the European Union on 16 June 2010 (2010/C 156/01).
[281] See part A of the Council Resolution.

a.) there are insufficiently valid economic or commercial reasons for the profit attribution, which therefore does not reflect economic reality;
b.) the incorporation does not essentially correspond with an actual establishment intended to carry on genuine economic activities;
c.) there is no proportionate correlation between the activities apparently carried on by the CFC and the extent to which it physically exists in terms of premises, staff and equipment;
d.) the non-resident company is overcapitalised, it has significantly more capital than it needs to carry on its activity;
e.) the taxpayer has entered into arrangements which are devoid of economic reality, serve little or no business purpose or which might be contrary to general business interests, if not entered into for the purpose of avoiding tax.

Looking at the *Cadbury Schweppes* decision, the indicators outlined in the Resolution are not surprising and may certainly be helpful to identify artificial structures and therefore to separate artificial from non-artificial structures. However, if a Member State wishes to keep a CFC regime which solely focuses on non-resident entities, the latter regime has to provide for an escape clause for genuine economic activities. As outlined earlier, the "typical" CFC regimes are not restricted to income from merely artificial arrangements, but also focus on income from non-artificial arrangements. For this reason, I do not think that the Resolution is a big step forward towards a broader solution which is in line with economic and equity principles as well as the concept and the idea of an internal market.

8.8. The "Limited" Capital Export Neutrality Approach

8.8.1. General Aspects

Based on the earlier examinations it can be concluded that economic and equity aspects require income to be taxed in the state in which the income-producing activity is carried on, i.e. where the income is actually produced.[282] This is a clear statement in favour of a concept which is based on the principle of capital import neutrality. Of course, this should be particularly true within the EU where the objective of an internal market was described in Article 26 (2) of the TFEU as *"(...) an area without frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties."* The possibility of an unrestricted investment of a resident of one Member State in another Member State with a strict source-based taxation in the Member State of secondary establishment would certainly come closer to the objective of an internal market than the application of the principle of world-wide taxation in the Member State of primary establishment. The differentiation may be less relevant in cases in which the Member State of primary establishment imposes a lower taxation than the Member State of secondary establishment, but in the opposite case, the principle of world-wide taxation may have a distorting effect on the investment in the Member State of secondary establishment. The income derived in the latter state would finally be subject to the higher taxation of the Member State of primary establishment and this might hamper the (income) tax competition among Member States. Tax competition - as long as it cannot be considered harmful through the establishment of special tax regimes and "ring-fencing" regimes - is one of the important factors to improve

[282] See chapters 2 and 3.

efficiency within the EU. However, the reduction of the income tax rate in one Member State may only have the effect of attracting capital if the Member State of the investor provides for a tax system which allows the investor to take advantage of the lower tax rate. In principle, the Member State which provides for a reduction of the domestic tax rate should be rewarded for its efforts to improve the overall efficiency by being granted the sole right to tax the income produced within its borders.

In its case law the ECJ made it very clear that any compensatory taxation is not acceptable. For example, in the *Eurowings* case, the Court stated that the *"(...) difference of treatment can also not be justified by the fact that the lessor established in another Member State is there subject to lower taxation. Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State. As the Commission rightly observed, such compensatory tax arrangements prejudice the very foundations of the single market*."[283] In his Opinion to the *Eurowings* case Advocate General Mischo pointed out that *"(i)f differences in the direct taxation of undertakings could be "neutralised" by compensatory levies imposed by Member States on intra-Community movements of goods, services and capital, little would remain of those fundamental freedoms. Virtually all goods and services moving between Member States would be subject to one compensatory levy or another. Member States and undertakings must in principle accept differences in fiscal charges in the same way as differences in social charges or labour costs*."[284] A similar statement was made by Advocate General Léger in the *Cadbury Schweppes* case.[285] With respect to the question whether a differentiation could be made on the basis of the tax rate in the other Member State the Advocate General held that "*(...) such a situation would manifestly lead to a result contrary to the very notion of "single market*"[286] and *"(t)he fixing of rates of corporation tax falls (...) within the unfettered competence of each Member State and Articles 43 EC and 48 EC confer on every company in accordance with Article 48 EC the right to set up a subsidiary in the place of its choice within the Union. A Member State may not, therefore, treat differently its resident companies which establish subsidiaries in other Member States depending n the tax rate applicable in the host State."* [287] Thus, any compensatory taxation (or "neutralisation"), i.e. the imposition of a higher domestic taxation just because of the fact that the tax rate in the other Member State is lower, is clearly prohibited. However, the prohibition of a compensatory taxation and therefore the recognition of the tax rates of another Member State should by no means lead to the conclusion that the principle of capital export neutrality has to be rejected under all circumstances and in any situation. Despite the clear preference for the application of the principle of capital import neutrality from an economic perspective and equity perspective - as outlined in previous chapters - and the fact that, in my opinion, the principle of capital import

[283] Case C-294/97 (*Eurowings*), paragraphs 43-45; see in this respect also case C-422/01 (*Skandia*), paragraph 52 and case C-136/00 (*Danner*), paragraph 56; case C-196/04 (*Cadbury Schweppes*), paragraph 49.
[284] Advocate General Mischo, Opinion of the Advocate General (case C-294/97 - *Eurowings*), paragraph 59.
[285] Advocate General Léger, Opinion of the Advocate General (case C-196/04 - *Cadbury Schweppes*), paragraphs 79 to 83.
[286] Advocate General Léger, Opinion of the Advocate General (case C-196/04 - *Cadbury Schweppes*), paragraph 80.
[287] Advocate General Léger, Opinion of the Advocate General (case C-196/04 - *Cadbury Schweppes*), paragraph 81.

neutrality fits the idea and the concept of an internal market much better than the principle of capital export neutrality, one must not overlook the fact that the ECJ accepted the credit method for the avoidance of double taxation (and therefore to a certain extent the principle of capital export neutrality) as a system which can be applied within the EU for the elimination of double taxation.[288]

8.8.2. The Necessary Differentiation

The preference for the principle of capital import neutrality is one thing, the existing legal environment in the light of the OECD-MTC another. The question whether the principle of capital export neutrality can play an acceptable - perhaps limited - role in the EU can only be answered with a more differentiated view. In this respect, it is important to recognise that the ECJ, in principle, accepted the allocation of taxing rights based on the OECD-MTC. In the *Gilly* case, the Court stated that *"(w)hilst abolition of double taxation within the Community is (…) one of the objectives of the Treaty, it must none the less be noted that (…) no unifying or harmonising measure for the elimination of double taxation has yet been adopted at Community level, nor have the Member States yet concluded any multilateral convention (...). The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation - by means, inter alia, of international agreements - and have concluded many bilateral conventions based, in particular, on the model conventions on income and wealth tax drawn up by the Organisation for Economic Cooperation and Development ('OECD')."*[289] Clearly, the fact that certain tax rules are consistent with the provisions of the OECD-MTC does not necessarily mean that they comply with the basic freedoms of the TFEU.[290] However, there is no reason to assume that - for example - the allocation rules of Articles 7, 10, 11, 12 and 21 of the OECD-MTC, as such, are not in line with the TFEU. It was outlined earlier that the allocation of taxing rights according to the aforementioned articles is one of the main reasons for the necessity of an anti-deferral legislation.

In general, if a resident investor of one Member State (Member State A) carries on a business activity in another Member State (Member State B) through a subsidiary company, the income of this subsidiary company should be taxed in the Member State where the income-producing activity is carried on. This is required by economic and equity considerations, and one could argue that it is equally required by the idea and the concept of an internal market (see above).[291] If the double tax convention between the two Member States is drafted along the lines of the OECD-MTC, the income will be taxed in the Member State of secondary establishment as long as no permanent establishment exists in the Member State of primary establishment (or any other state).[292] Hence, as long as the income of the subsidiary company is produced in the Member State of secondary establishment and not distributed to the shareholder, it will be subject to income taxation in the Member State of secondary establishment only. Based on the arguments above, the Member State which provides the benefits for the income production should receive the right to tax the

[288] More details and references to the case law of the ECJ are included in section 8.2.5.8.
[289] Case C-336/96 (*Gilly*), paragraphs 23, 24.
[290] See in this respect also the Opinion of the Advocate General to case C-324/00 (*Lankhorst-Hohorst*), paragraphs 80, 81 and the extensive examination of Pistone in Pistone, The Impact of Commuity Law on Tax Treaties, Issues and Solutions, EUCOTAX Series on European Taxation, 2002.
[291] See sections 2.4.1. and 3.2.3. with respect to economic and equity considerations and direct investments.
[292] See Article 7 (1) of the OECD-MTC.

"fruits" of the activities.[293] If it is a Member State with a low level of taxation, it will be rewarded for its improvement of the overall efficiency.[294] Otherwise, i.e. if the Member State with the low level of taxation does not receive the sole right to tax the income, this might seriously distort the capital investments among Member States with the effect of hampering (sound) tax competition. Again, the reduction of tax rates can only pay off for the respective Member State if it leads to an unrestricted taxation of income in the latter Member State. Any protectionist approach followed by the Member State of primary establishment, e.g. through an undifferentiated application of CFC rules, would hamper the overall improvement of efficiency.[295]

However, the situation will be different if an additional subsidiary company comes into play - in another (third) Member State (Member State C) - with the main purpose of providing capital to the other subsidiary company in Member State B. If it is assumed that all of the three Member States involved have concluded double tax conventions with each other which are drafted along the lines of the OECD-MTC, there might be a shifting of taxing rights which is neither in line with the economic and equity considerations nor with the preferred solution of a source-based taxation in an internal market.[296] In this respect, it is important to note that it is not the provision of capital in the form of equity which is relevant here, but the provision of capital in the form of loan amounts, the investment in bonds, the leasing and renting out of assets, the licensing out of intangible assets (e.g. rights), and similar contractual relationships and services. They all have in common that a substantial amount of income related to these activities is *not* taxed in the Member State where the income is produced (here: Member State B), but in the Member State where the service provider carries on its activities (Member State C). This is due to the fact that the double tax convention between the Member States B and C - which is based on the OECD-MTC - provides for an allocation of taxing rights related to the total amount of income, or at least a substantial amount of income, to Member State C.[297] This can be based, *inter alia*, on Article 7 of the OECD-MTC (e.g. in case of leasing income which is related to tangible assets), Article 11 of the OECD-MTC (e.g. in case of interest income related to loan amounts and the investment in bonds - with a limited taxation at source), or Article 12 of the OECD-MTC (e.g. in case of royalty income related to intangible assets). The allocation of taxing rights is - in this situation - solely based on the double tax convention between the Member States B and C. However, from the perspective of Member State A it is obvious that just the direct relationship A-B and A-C is covered by the respective double tax conventions (and not B-C), and it is theoretically required - in the same way as outlined above - that the income produced in Member State B is to be taxed in Member State B, and that the income produced in Member State C is to be taxed in Member State C.[298] However, this is not the outcome of this triangular situation, at least not with respect to the total amount of income. Based on the earlier examinations, a substantial part of the income is produced in Member State B, but not taxed in this Member State (due to the allocation of the taxing rights in the double tax convention between Member States B and C). In contrast thereto, Member State C taxes the complete amount of income received from Member State B, even though only a minor portion is actually

[293] See sections 2.4. and 3.2.3.
[294] Always under the assumption that it is not a special tax regime, ring fencing regime, and so on.
[295] See section 2.4.
[296] See sections 2.4.4., 2.5. and 3.2.6.
[297] See sections 2.5., 3.2.6. and 3.3.5.
[298] See sections 3.3.5.

produced in the first-mentioned Member State. Even if one takes into account the risks related to the investment of subsidiary company C, it becomes obvious that the basic interest component which was outlined in chapters 2 and 3 is completely unconnected to Member State C.[299] Again, it is absolutely clear, in my opinion, that the income which is actually produced in Member State C should be taxed in the latter state and not in Member States A or B - even if it is just a minor portion of the allocable income. This is an approach which is based on the principle of capital import neutrality and the recognition of the tax rate applicable in the respective Member States. Income which is produced in a particular Member State should be taxed according to the principles and the tax rate of this Member State and should not be attributed - based on the principle of capital export neutrality - to any other Member State. However, if the Member States B and C stipulate a different allocation of taxing rights in their double tax convention, the question arises whether EU law requires that this has to be recognised by Member State A, too. With respect to the income which is related to the basic interest component it is difficult to argue that this portion of income *must* be taxed in Member State C instead of Member State A from an EU law perspective. This portion of income is neither produced in Member State C nor is it required to compensate for any additional risks taken in the latter Member State. It is just the result of an allocation of taxing rights stipulated in the double tax convention between Member States B and C. Furthermore, the limitation to taxation in Member State C does not lead to an efficient allocation of capital. The contrary might be true if Member State C is a country with a relatively low income tax rate. If Member State C has concluded comparable double tax conventions with other Member States, this might attract equity investments from those Member States (and third countries) with the purpose of routing the financial means to the places where they are actually utilised for an income-producing activity. However, equity is transformed into loan amounts as well as tangible and intangible assets in Member State C which are subsequently made available to the contract partners by way of loan agreements, leasing agreements, licensing agreements and similar agreements. This will then have the effect of a shifting of taxing rights from the high-tax Member States to the low-tax Member State C. Again, the contract partners are usually not established in Member State C, with the effect that the equity investment of - for example - Member State A will finally be utilised in Member State B for an income producing activity. Such a "clustering" of equity investments in a particular Member State - with the effect of a shifting of taxing rights - will by no means lead to an efficient allocation of capital. Or, at least, the place of (final) economic investment will not go hand in hand with the place where the income-producing activity is finally subject to tax.[300] In my opinion, this does not have anything to do with the question whether an economic activity is carried on in the Member State of the CFC or not. The underlying assumption in all of these considerations is that (at least) a minor economic activity is carried on in the CFC state. However, the taxable income derived by the entity in state C is higher than the sum of income which is related to the functions "physically conducted" in this Member State and the portion of income to cover the risks involved in the activity. However, it was outlined earlier that the limited activity in the Member State C is not necessarily problematic with respect to the question whether the activity is within the scope of a basic freedom or not.[301] Overall, it can be concluded that a strict source-based taxation comes closer to the concept of an internal market. However, to the extent that income is shifted from the

[299] See sections 2.4.5. and 3.2.6.
[300] See sections 3.2.6. and 3.3.5.
[301] See sections 8.2.1.1. and 8.2.1.2.

Member State where it is produced to an intermediate Member State where capital is transformed from equity into “services,” and where the income can neither be seen as a compensation for the exercising of functions in the intermediate Member State nor as a compensation for the taking over of certain risks, there is, in my opinion, no requirement from an EU law perspective to tax this particular portion of income in the Member State of the intermediate subsidiary company.

This becomes particularly obvious if the services of subsidiary company C are also provided to the parent company in Member State A, e.g. by the provision of financial services. If the double tax convention is based on the OECD-MTC, the interest payments would normally reduce the tax base in Member State A and would be taxable in Member State C. Here, the equity originates from Member State A and is transformed from equity into “services” in Member State C. A certain amount of income is now allocable to Member State C - merely through the effect of transformation - and reduces the tax base in Member State A, even though it is quite clear that the income-producing activity, i.e. the activity which “creates” the interest, is carried on in Member State A. Clearly, all accompanying activities which are “physically conducted” in Member State C should be taxed in this Member State. In addition, it can be argued that the risk compensation should be taxed in Member State C, too, since a possible default will reduce the domestic tax base in the latter Member State. However, there is - in my opinion - no comparable argument for the income taxation of the basic interest component in Member State C. This would not have anything to do with an efficient allocation of capital. It is just the result based on the bilateral convention concluded between the two Member States A and C. However, this should not preclude Member State A - neither from an EU law perspective nor from the perspective of the underlying double tax convention - from taxing the basic interest income on a current basis according to the principle of capital export neutrality.

8.9. Conclusions

1.) The primary EU law has a significant influence on the CFC regimes of the Member States. The investment in companies which trigger the application of CFC rules may be in the scope of the freedom of establishment and / or the free movement of capital. Theoretically, the activities of the CFC might also be - depending on the facts and circumstances of the case - in the scope of the freedom to provide services.

2.) In order to come within the scope of the freedom of establishment the CFC must pursue a genuine economic activity through a fixed establishment in another Member State for an indefinite period. The mere holding of assets cannot be considered an economic activity, but a certain (minimum) economic output is required in the host Member State. In principle, the mobile activities which were described in previous chapters are also covered by the freedom of establishment as long as the aforementioned requirements are fulfilled. In essence, the investment in a CFC is not to be seen differently from any other investment in a foreign company.

3.) In the *Cadbury Schweppes* case, the first case dealing with CFC legislation, the ECJ made it clear - based on settled case law - that an activity cannot be considered a wholly artificial arrangement if the CFC is genuinely established in the host Member State and has the premises, staff and equipment necessary to carry out the services.

4.) The examination shows that the freedom of establishment and / or the free movement of capital prevail over the freedom to provide services. This is not only true in cases where the services of the CFC are directed towards the shareholder in the CFC, but also in cases where the services are provided to a recipient in another state who does not have any investment in the CFC. The freedom to provide services is therefore of no particular relevance in the context of this study.

5.) The free movement of capital plays a less important role in the case law of the ECJ than it could be expected from its very broad scope of application. The reason is that - based on the case law of the ECJ - there are important situations where the freedom of establishment prevails over the free movement of capital. The following differentiation can be made:

A. (Part of) CFC legislation which requires definite influence over the decisions of the CFC	the following basic freedoms are affected:
a.) CFC in another Member State	Article 49 TFEU
b.) CFC in a non-member state	---
B. (Part of) CFC legislation which does not require definite influence over the decisions of the CFC (e.g. FIF type legislation)	the following basic freedoms are affected:
a.) CFC in another Member State	
aa.) definite influence (actually)	Article 49 TFEU
ab.) no definite influence (actually)	Article 63 TFEU
b.) CFC in a non-member state	
ba.) definite influence (actually)	Article 63 TFEU (uncertain)
bb.) no definite influence (actually)	Article 63 TFEU

6.) The question whether the CFC legislation can result in a restriction on the exercising of the aforementioned basic freedoms can be answered in the affirmative. In fact, there are a number of possible restrictions which can be caused by the application of CFC rules and which are dependent on the situation of the shareholder who is subject to CFC taxation. Most of the disadvantages were already identified in the case law of the ECJ as restrictions on one or more of the basic freedoms. The restrictions may range from liquidity and administrative disadvantages to a massive double taxation of income.

7.) In order to identify a restriction which is caused by the application of CFC rules, it is important to determine the appropriate pair of comparison. The examination shows that the pair of comparison has to be limited to a mere vertical comparison and cannot be extended to a horizontal comparison.

8.) The examination further shows that the theoretical acceptance of a horizontal comparison would not result in an obligation for the Member State of primary establishment to provide for a "most-favoured nation" treatment. Firstly, up to now the most favoured nation treatment has not been accepted by the ECJ and, secondly, the CFC rules are solely national legislation - and not tax treaty provisions - which do not provide any basis, in my opinion, for such a far-reaching obligation.

9.) A number of possible arguments for the justification of a restriction on the exercising of the basic freedoms can come up in a CFC case. The following arguments were identified and examined in this context.

- the cohesion of the tax system;
- the loss of tax revenue and the erosion of the tax base;
- the lower taxation in the CFC country,
- the principle of territoriality;
- the protection of a balanced allocation of the power to impose taxes between Member States;
- the effectiveness of fiscal supervision;
- the aim of preventing tax avoidance;
- the principle of world-wide taxation.

The examination shows that the above arguments cannot be accepted as a valid justification in a CFC case. Given the fact that the CFC regimes are usually structured as anti-avoidance (anti-deferral) legislation, the aim of preventing tax avoidance is certainly one of the most obvious arguments. However, it is clear from the *Cadbury Schweppes* case and previous decisions that such legislation must focus on wholly artificial arrangements. Clearly, this is not the case for the CFC regimes which were outlined in chapter 6 and which have not been amended after - and according to - the *Cadbury Schweppes* decision. These CFC regimes are applicable in an undifferentiated manner to different types of low-taxed income and are actually *intended* to be applicable to income derived from genuine economic activities. For this reason, the aforementioned CFC concepts will not be proportional as long as they do not provide the shareholder with the possibility of submitting evidence that the activity carried out in the other state is a genuine economic activity - and to be exempt from CFC taxation in such a situation. From my perspective, the outcome of the *Cadbury Schweppes* case is neither mitigated through the VAT case law of the ECJ nor the subsequent *Oy AA* decision. In VAT cases, the national court has to make an overall assessment and has to decide whether the tax motive is essential compared to the non-tax explanations (such as economic objectives). For this reason, the structure can be considered abusive from a VAT perspective despite the fact that economic objectives exist. In contrast thereto, if a CFC is genuinely established in another state, it does not play a role whether or not the saving of (income) taxes was the principal aim of the relocation. With respect to the Oy AA decision - a case dealing with a provision of the Finnish corporate income tax system - I have made it clear that, in my opinion, the fact that the ECJ accepted a system which was not specifically designed to target wholly artificial arrangements is only due to the fact that the justification was (also) based on the protection of a balanced allocation of the power to impose taxes between Member States. From my perspective, it was completely misleading to put forward the aim of preventing tax avoidance in a situation where another justification requires a much broader scope - and which may therefore also require an acceptance in case of genuine economic activities. The subsequent decision in *X Holding* is in line with the above conclusions. The reason is that the ECJ considered the need to safeguard the allocation of the power to impose taxes between Member States to be a valid and ‘exclusive’ justification which does not have to be accompanied by another justification

10.) The requirement of giving the taxpayer the possibility of submitting evidence that the CFC carries out a genuine economic activity should be equally relevant for investments in non-member states. However, based on the case law of the ECJ, the Member States may require that a legal basis exists for information exchange between the competent tax authorities of the respective Member State and the non-member state where the investment was made, e.g. based on a double tax convention. Such an additional requirement is needed because of the fact that the Council Directive 77/799/EEC is not applicable in case of non-member states. An information exchange clause ensures, therefore, that the information provided by the taxpayer can be verified. Overall, there are some cases dealing with the latter aspect in relation to non-member states and it is obvious that the existence or non-existence of an information exchange clause may be decisive for the question whether a restriction can be justified or not. However, it is my understanding that the existence of an information exchange clause on a bilateral basis is to be taken into account as well and - depending on the situation - may have the same relevance for the ECJ as the Council Directive 77/799/EEC.

11.) The CFC regimes can be directly and indirectly influenced by secondary EU law. A direct influence exists, in my opinion, in case of the Parent-Subsidiary Directive. The amended version of the latter Directive not only covers profit distributions but also the current taxation of income derived through a hybrid entity. In my opinion, it would be neither logical nor consistent to consider the CFC income attribution to be outside of the scope of the Parent-Subsidiary Directive. The Parent-Subsidiary Directive determines that either the exemption method or the credit method has to be applied for the elimination of double taxation. In case of a hybrid entity, the subsequent profit distribution - which was already subject to a current taxation of income - should be exempt from domestic taxation. In general, the latter mechanisms are already offered by almost all CFC regimes and I do not expect substantial changes which are based on the Parent-Subsidiary Directive. However, the Directive becomes an additional limitation for changing the structure of CFC regimes.

12.) An indirect influence of secondary EU law exists in case of the Interest and Royalty Directive. The examination shows that the abolition of a limited source-based taxation (withholding taxation) may clearly support the structures which are typically in the focus of CFC regimes. The non-existence of a withholding tax credit (due to the fact that there is no withholding tax) on the level of an intermediate finance company may considerably improve the situation of the state where the latter company is established. Moreover, the abolition of a withholding taxation in the country where the income is produced is, despite all administrative simplifications, contrary to the economic and equity principles derived from chapters 2 and 3.

13.) In my opinion, the case law of the ECJ results in a dilemma for those Member States which apply CFC regimes: either they provide an “escape clause” for genuine economic activities or the CFC regimes, in their current structure, will not be in line with the freedom of establishment and / or the free movement of capital. The examination in previous chapters shows that it is the intention of the CFC regimes to currently tax income derived from genuine economic activities and not necessarily from wholly artificial arrangements. The latter arrangements are usually covered by other anti-abuse measures. For this reason, I do not think that the implementation of an escape clause for genuine economic activities is an appropriate solution for a great number of these Member States.

14.) In principle, it is understandable that Member States with a comparably high tax rate want to protect their tax revenues and want to stop the erosion of the domestic tax base in favour of low-tax countries and territories. However, it is equally clear that “tax competition” should be supported as long as it is sound competition among states which leads to an efficient allocation of resources. Such competition is clearly supported by the economic and equity principles outlined in chapters 2 and 3. However, this has to be separated from harmful competition which is triggered by countries and territories which have an over-proportional advantage from the inflow of capital and mobile investments to the detriment of other states. In the latter case, the state or territory which attracts the capital is usually merely an intermediate location and the income - based on the employment of such capital - is produced outside of this state or territory. The latter situation is not supported by the economic and equity principles outlined in previous chapters and the Member State should have the possibility of applying legislation which - directly - targets the structures which result in such harmful competition. In my opinion, the taxation of the basic interest component of capital for certain mobile investments - without making a differentiation based on the place of investment - could be a very efficient approach without restricting sound competition.

15.) The approaches of the Member States in order to comply with EU law and, in particular, the *Cadbury Schweppes* decision are different. This can be shown by the following country examples:

- Finland: the amended CFC regime provides an exemption from CFC taxation for entities which are established in an EEA state or a tax treaty state whose tax system does not differ substantially from the Finnish tax system, provided that an exchange of information is possible with the other state. In addition, it is required that the entity is actually established and carries on a genuine economic activity in the host state.

- France: the French CFC regime provides for an EU entity exemption to a shareholding in the foreign entity which does not constitute a wholly artificial arrangement intended to escape French tax. The notion of a wholly artificial arrangement must be assessed with regard to the objective criteria arising from the ECJ case law. The exception applies to participations held by French corporations, but not by French individual shareholders.

- Germany: the amended CFC regime grants an exemption from CFC taxation for EU/EEA state if the taxpayer can provide evidence that the CFC carries out a genuine economic activity in the host state. In addition, it is required that an appropriate procedure for collaboration and exchange of information is established between Germany and the other state. It remains unclear what is actually meant by genuine economic activity. Moreover, it is stated that only income which is derived through the activity of the CFC itself can be allocated to the genuine economic activity and only to the extent that the arm's length principle is taken into account.

- Italy: the CFC regime does not result in a current allocation of income if it can be demonstrated that the entity carries out an "effective business activity." However, it has to be noted that the latter activity is not necessarily the same as the "genuine economic activity" which was described in the *Cadbury Schweppes* decision. Moreover, the exemption from CFC taxation is completely dependent on a positive ruling of the Italian tax authorities.

- The United Kingdom: different proposals for an amendment of the CFC regime have been discussed. The proposals range from the rather innovative system of a deduction of the "net economic value" from the allocable amount of income (which essentially results in a vertical separation of income) to the switch from the exemption method to the transactional method and the application to resident and non-resident entities. A concrete proposal for a new CFC regime was published in June 2011 which, however, seems to be an amendment to the "CFC type" rules but not the introduction of an innovative system. In my view, it is more than questionable whether the proposed regime can really restrict the application to wholly artificial arrangements.

- Denmark: the revised regime is now applicable to resident and non-resident entities without any link to the effective tax rate. The regime shall apply to participations of more than 50 percent and only to subsidiaries which derive more than 50 percent financial income and which have at least 10 percent financial assets. The undifferentiated and non-discriminatory approach does not provide an exemption for genuine economic activities carried out by the respective entity.

- Sweden: the new Swedish regime grants an exemption from CFC taxation if the foreign entity "constitutes an actual establishment from which activities conducted for business reasons are carried out." In this regard, several factors shall be taken into account for the assessment. According to the preparatory work of the revised legislation, the provision must not be interpreted as more far-reaching than what is allowed by the *Cadbury Schweppes* decision. The revised legislation will be relevant for establishments within the EEA.

16.) From my perspective, the strict limitation of an exemption from CFC taxation to EU Member States and EEA States should not be acceptable from an EU law perspective. Depending on the situation, the free movement of capital may require an unrestricted access to non-member states. Of course, the requirements for investments in non-member states may partially deviate from those which are needed in case of investments in other Member States, e.g. with respect to the existence of an information exchange between the respective states, but this cannot lead to the outcome that an exemption from CFC taxation, for example based on the existence of a genuine economic activity, is - in general - not granted to the shareholder (i.e. even if the additional requirements are fulfilled).

17.) The examination shows that the principle of capital import neutrality fits the idea and the concept of an internal market much better than the principle of capital export neutrality. The Member State which provides the benefits for the income production should have the right to tax the “fruits” of the activities. If it is a Member State with a low level of taxation, it will be rewarded for its improvement of the overall efficiency. Otherwise, i.e. if the Member State with the low level of taxation does not receive the sole right to tax the income, this might seriously distort the capital investments among Member States with the effect of hampering (sound) tax competition. Any protectionist approach followed by the Member State of primary establishment, e.g. through the undifferentiated application of CFC rules, would hamper the overall improvement of efficiency. This is fully in line with the conclusions drawn in this chapter and in previous chapters.

18.) However, the (theoretical) preference for the principle of capital import neutrality is one thing, the existing legal environment in the light of the OECD-MTC another. Thus, as long as the residence-based taxation is the prevailing system for income from capital intensive mobile activities, there is still the possibility of shifting income from the latter activities to intermediate companies in low-tax states - with the effect that the right to tax the total amount of income is also shifted to the latter states. This, however, is neither in line with the conclusions drawn in previous chapters nor with the idea and the concept of an internal market.

19.) In my opinion, the conclusions from this chapter and the previous chapters clearly support, in my opinion, the concept of a “limited” capital export neutrality approach, i.e. an approach which focuses on the current taxation of the basic interest component. It seems to me that this is the only possibility of bringing together the essential elements of an internal market with the previous conclusions and the needs of Member States for an acceptable anti-avoidance (anti-deferral) regime. Such an alternative concept will be presented in the following chapter.

9. Alternative to the Existing CFC and FIF Legislation

9.1. Introduction

In my opinion, the previous chapters show clearly that there is no room for a broad CFC-type anti-avoidance legislation in the European Union which, at the same time, fulfils the requirements under the TFEU and takes into account important economic and equity principles. This does not mean, however, that there is no necessity for and no possibility of a current taxation of income, but it requires Member States to follow a more "balanced" approach which refrains from one-sided restrictions (e.g. because of the income tax rate). It is unlikely, however, that all of those Member States which currently apply CFC regimes will be in a position to strictly follow the ECJ by limiting such legislation to merely abusive structures, i.e. wholly artificial arrangements. As I have stated earlier, the limitation to wholly artificial arrangements would change the focus and the aim of such legislation completely. On the one hand, I think that some of the latter Member States simply cannot afford to follow the route opened by the ECJ. On the other hand, the undifferentiated current taxation of income generated by resident and non-resident companies - based on the transactional approach or the entity approach - may not be the appropriate solution, either. However, it is clear that the Member States which follow the "typical" CFC regimes outlined in chapter 6 are forced to react and to adapt their regimes in one way or another. The regimes which are not in line with the conclusions drawn from *Cadbury Schweppes* have to be amended at least in a way which either limits the scope to wholly artificial arrangements or which extends the application to resident entities.

From my perspective, what is really required - and what is going beyond a 'minimal' adaption of CFC regimes - is an anti-avoidance approach which can be applied in an internal market and which combines EU law requirements with economic and equity principles. The legislation must be effective in targeting the avoidance of domestic taxation but, at the same time, must not disturb the efficient allocation of capital. This, however, cannot be achieved through a concept which merely focuses on the separation of certain *types of income* (or a concept which does not provide for *any* separation), but only through a concept which also takes into account the separation of *specific income components*. In other words, it must be a concept which provides a system of horizontal and vertical separation of income. In the following, I will outline the main aspects, elements and the conceptual framework - based on the conclusions of the previous chapters - before going into detail regarding an alternative anti-avoidance legislation.

9.2. The Anti-Avoidance Aspects

It is obvious from the earlier examinations that the existing CFC regimes are not in line with EU law if they are solely applied to low-taxed non-resident entities. However, it is equally clear that specific anti-avoidance rules which focus on merely artificial arrangements cannot provide an appropriate substitute for CFC legislation. The implementation of service companies in low-tax states cannot be seen as artificial - at least not in general.[1] One should always keep in mind that the main purpose of CFC rules is often *not* the targeting of artificial structures but the current taxation of low-taxed income which is retained in foreign legal entities and is therefore sheltered from

[1] See in this respect the outcome of the *Cadbury Schweppes* case which was outlined earlier.

domestic taxation.[2] The CFC rules are measures against the erosion of the domestic tax base towards low-tax countries and can therefore clearly be seen as anti-avoidance (anti-deferral) measures which are considered necessary by a large number of European Member States. However, the accumulation of low-taxed income within the foreign legal entity as such cannot be considered “abusive” in a stricter sense - this is already clear from the existing case law of the ECJ. But the aforementioned “clustering” of equity investments in low-tax states with a subsequent switch to debt investments[3] in triangular cases may have a negative effect for high-tax Member States and does not improve and support the efficient allocation of capital within the European Union. In fact, it may lead to inefficient capital allocations. In order to target such structures - or rather the negative effect of such structures - it is from an anti-avoidance perspective neither necessary nor acceptable to allocate all of the income derived by the foreign legal entity to the domestic shareholder. What is required, however, is an additional separation of income components - instead of a mere separation of active and passive income. In this regard, the following differentiation of income components should be made:

- income related to an activity physically conducted in the state of the service company (activity component);

- income related to the compensation of risks which are related to the capital investment (risk component);

- income related to the basic interest component of capital (basic interest component).

All of the three components are usually included in the income which is related to services where the main purpose is the provision of capital.[4] It is obvious from the examinations in previous chapters that there is, in principle, a justification for a different treatment of the three income components from the perspective of the residence state of the shareholder. In my opinion, the horizontal and vertical separation of income can be the key for an efficient anti-avoidance system which is in line with EU law. In the following, I will briefly come back to the three income components and subsequently describe an alternative system.

9.2.1. Income Related to the Activity Component

The portion of income which is (directly or indirectly) related to an activity physically conducted by personnel in the state of the CFC should not be in the focus of any current taxation of income. This should not only be true for income which is related to production and trading activities, but also for any type of service activities, irrespective of whether the activities are provided to related or unrelated parties. The latter differentiation between related or unrelated parties does not make much sense - from an economic perspective - since the economic output created in the CFC state is independent from this differentiation. Moreover, it should not be decisive whether the activity can be seen as an important or less important activity (e.g. within a

[2] At least, this is the conclusion derived from chapter 5 (see, *inter alia*. section 5.5.) and chapter 6 (where the various types and the specific elements of European CFC and FIF rules are described).
[3] Directly (e.g. by loan agreements) or indirectly (e.g. by leasing agreements, royalty agreements).
[4] The income components are, of course, also included in services where the main purpose is not the provision of capital, but where capital is employed for the provision of services.

certain group of companies). The fact that the portion of income is related to the economic output created by personnel in the CFC state excludes, in my opinion, the possibility that this portion of income can be qualified as "abusively" shifted to another state - at least, this is true as long as the relocation of activities cannot be considered completely "useless" and without any value for the group. In this respect, one should clearly follow the principle of capital import neutrality and avoid any current taxation of such income in the Member State of the shareholder. Apart from the fact that such a taxation would be contrary to the concept of an internal market, it is - in my opinion - rather obvious that the portion of income which is related to the economic output created by the activity of CFC personnel is usually less mobile than other income components, especially the income which is related to the employment of capital. Thus, it is less likely, in my opinion, that activities which are strongly based on the activity of personnel are relocated to other countries merely for tax reasons. But even if the lower taxation is the triggering factor for the relocation, the effect which may be achieved - compared to the administrative, legal and other burdens which go hand in hand with such relocation - seems to be rather insignificant. In my opinion, this is supported by transfer pricing principles: the complex and important group activities (e.g. R&D activities) typically require a higher margin from a transfer pricing point of view. Even though the higher margin provides the possibility of shifting more income to another state, it is equally clear that especially those activities require highly skilled personnel, appropriate facilities, and a legal and administrative environment which supports the activities. This makes the activities less mobile and it is therefore rather unlikely, or at least less likely, that they are solely relocated for tax reasons. However, the less complex and less important group activities (e.g. a call centre) may only achieve - based on transfer pricing principles - a lower margin. Thus, the mobility increases but the profit margin decreases. This, again, is not the result a tax planner wants to achieve. It was outlined earlier that it is much more effective to relocate capital intensive activities in order to make sure that a substantial amount of (interest) income is allocable to the low-tax state. Apart from the higher degree of income related to the employment of capital, the services still require the carrying out of an activity which is physically conducted by personnel in the CFC state. With respect to the activities which are usually in the focus of CFC regimes (e.g. financing activities, leasing activities, licensing activities), it can certainly be concluded that the part which is carried out by personnel is often a rather less complex activity. Nonetheless, the aforementioned principles are equally applicable in case of capital intensive services: the income which is related to the economic output created by personnel in the CFC country should be taxed in the state where the income is produced. This decision should be independent from the question whether the overall income is increased by elements which are related to, for example, the employment of capital. An acceptable and efficient approach - especially in the context of an internal market - requires a separation of those elements.

9.2.2. Income Related to the Risk Component

The income which is related to the compensation of the (increased) risk of the investment is not produced by the activity of personnel in the CFC state.[5] It is produced in the state where the activity is carried on and where the capital (either in the form of financial means or in the form of tangible or intangible assets) is employed for an income producing activity. Of course, the aforementioned activities

[5] In case the investment is made outside of the state of residence of the CFC.

of the CFC personnel are not free of risks. However, the compensation should be included in the income directly related to these activities and must be seen separately from the risks involved in the investment itself. Clearly, it is the decision of the person(s) in the CFC state which matters (e.g. in case of an asset management activity) and this function must therefore be compensated appropriately. However, the subsequent (increased) payment for the compensation of a certain investment risk is only indirectly related to the decisions of the CFC-management. It is paid because of the decision to take a higher risk, but it is nonetheless a direct compensation for the risk itself. What the asset manager tries to achieve is either a higher return on investment when taking comparable risks (e.g. within a certain risk category) or a comparable rate of return by taking a lower risk than normally required. Again, this must find expression in the income related to the asset management activity. But it has to be seen differently from the risk compensation as such.

For example, if a company had decided in October 2008 to invest in 4.750% Turkish state bonds with maturity date in 2012, the expected yield would be 7.60 percent.[6] In contrast thereto, the investment in 4.250% German state bonds with maturity date in 2012 would only result in a yield of 3.60 percent - which is a difference of about 400 basis points.[7] However, the state bonds of Turkey are rated Ba3 and the state bonds of Germany are rated Aaa by Moody's.[8] The difference in interest rate is due to the increased risk which is involved in the investment in bonds which are rated Ba3 compared to bonds which are rated Aaa. It is a direct compensation for the increased likelihood that the interest payments and the repayment of the Ba3 bonds at a later point in time is less secure than the investment in the Aaa bonds.[9] It is therefore obvious that the income of the company may be increased simply by taking over additional risks, but this may be seen as a premium which compensates for the default of the debtor. Thus, if a double tax convention between the debtor state and the creditor state allocates the taxing rights to the latter state (as is the case in the OECD-MTC - apart from a possible limited taxation at source by way of withholding taxation), the creditor state should also take into account the possible losses caused by the default of the debtor.[10] If, in such a situation, the state of the shareholder taxes the positive income on a current basis which is related to the risk compensation, but excludes the losses from domestic taxation, it leads to an asymmetrical taxation of income. It would take away part of the income - through a higher taxation - which is required for the compensation of losses.[11] Hence, a symmetrical approach requires

[6] 4.750% Turkey 2005 (XS0223369322), maturity date July 06, 2012, the yield was determined on October 13, 2008 (see Boerse Online , 43/2008, page 108).
[7] 4.250% Bundesobligation 2007 (DE0001141513), maturity date October 12, 2012, the yield was determined on October 13, 2008 (see Boerse Online, 43/2008, page 108).
[8] See Boerse Online, 43/2008, page 108; the rating AAA (Standard & Poor's) / Aaa (Moody's) is the highest rating and reflects the lowest possible investment risk. The debtor is in a very good financial position. In contrast, the rating BB+, BB, BB- (Standard & Poor's) / Ba1, Ba2, Ba3 (Moody's) contains speculative elements. The long-term financial situation of the debtor is not secured.
[9] Statistically, the default risks of bonds within the investment grade sector are clearly lower than those of the high yield sector. See in this respect also the analysis of Zeuner, News aus den Finanzmärkten, Sind Unternehmensanleihen attraktiv?, November 18, 2008, which can be found in the internet under www.vpbank.com. In this analysis, the average default risk of the investment grade bonds for 2009 is calculated to be 6 percent and of the high yield bonds to be 16 percent.
[10] However, it has to be noted again that the risk itself is connected to the state of the debtor and an optimal scenario would therefore require the taxation in the state of the debtor (see in this respect especially chapter 2 and chapter 3).
[11] In case the tax rate in the state of the asset management company is lower than in the residence state of the shareholder.

either the exemption of the income related to the compensation or the taking into account of positive *and* negative income. However, if the risk compensation and the theoretical risks are balanced out, there is - in the long run - not much income potential which might be shifted to the low-tax state. “Balanced out” would theoretically mean that the risk compensation is as high as the theoretical risk over a longer period of time. The positive result which can theoretically be achieved is the over-compensation for the willingness to take the increased risk. However, this supposes a perfect market and an extremely high diversification rate. Studies show that even though the default rate of corporate bonds may be low (depending on the risk category), there is a significant likelihood that the losses caused by an unexpected default are very high.[12] It is difficult to compensate for these losses through the investment in other corporate bonds since the positive income which can be derived from these investments is limited. According to *Amato* and *Remolona*, an asymmetrical allocation exists between the positive income which may be achieved by the investment in corporate bonds and the extraordinary high losses. This is one of the main reasons why it is extremely difficult to diversify the investment in corporate bonds.[13] In fact, pursuant to *Amato* and *Remolona*, the diversification of investments in corporate bonds requires an extraordinary large number of different bonds.[14] In addition, the possibility of diversification is further restricted by the high degree of default correlation. There are two important factors which are relevant for the correlation: the risk category and the activity in the same field of business.[15] The higher the likelihood of default (because of a certain risk category), the higher the likelihood that it affects two companies (within the same risk category) at the same time. This is mainly due to a so-called “asset-correlation.” For companies within a high-risk category, a small decrease in value of the assets owned by the companies is sufficient to bring them into a situation of default.[16] The correlation is further increased when companies carry on their activities in the same field of business. The latter is, in my opinion, rather obvious: if two companies carry on their activities in the same business sector, it is likely that both companies will be affected if the economic environment in this particular sector deteriorates. Overall, *Amato* and *Remolona* have shown in their study that the lack of diversification and the lack of compensation of the permanent risk of unexpected defaults are most likely the reasons why the interest spread between the low-risk corporate bond investments and the high-risk investments (within certain categories) is higher than the mere statistical likelihood of

---

[12] Amato / Remolona, Das Rätsel der Bonitätsaufschläge, BIZ-Quartalsbericht, December 2003, page 57 et seq. (63).

[13] Amato / Remolona, Das Rätsel der Bonitätsaufschläge, BIZ-Quartalsbericht, December 2003, page 57 et seq. (63).

[14] Amato / Remolona, Das Rätsel der Bonitätsaufschläge, BIZ-Quartalsbericht, December 2003, page 57 et seq. (64). Even the extension of the corporate bond portfolio from 100 different bonds to 300 different bonds does not lead to an appropriate diversification. The probability of losses is three times higher than the losses which can statistically be expected within a (theoretical) completely diversified portfolio.

[15] Amato / Remolona, Das Rätsel der Bonitätsaufschläge, BIZ-Quartalsbericht, December 2003, page 57 et seq. (68); Zhou, Default Correlation: An Analytical Result, FEDS paper 1997-27, Federal Reserve Board; Gersbach / Lipponer, Firm Defaults and the Correlation Effect, European Financial Management, Vol. 9, pages 361-377; see also Das / Fong / Geng, Impact of Correlated Default Risk on Credit Portfolios, Journal of Fixed Income, December 2001, pages 9-19; Elton / Gruber / Agrawal / Mann, Explaining the Rate Spread on Corporate Bonds, Journal of Finance, February 2001, pages 247-277.

[16] Amato / Remolona, Das Rätsel der Bonitätsaufschläge, BIZ-Quartalsbericht, December 2003, page 57 et seq. (68); Zhou, Default Correlation: An Analytical Result, FEDS paper 1997-27, Federal Reserve Board; Gersbach / Lipponer, Firm Defaults and the Correlation Effect, European Financial Management, Vol. 9, page 361-377.

default.[17] From my perspective, what is typically seen as the compensation for the willingness to take the higher risk is therefore - in a broader sense - also an element of risk compensation.

Clearly, the relocation of income related to an investment activity - and therefore the taking over of risks by the asset management company - is easier than the relocation of income related to business functions which are solely (or mainly) based on the activity of personnel. However, the “net result” which can be seen as the risk compensation minus the losses caused by the actual realisation of risks is difficult to estimate and therefore, in my opinion, not particularly attractive for any planned - “tax driven” - relocation of income to a low-tax state. This, however, requires a balance between the theoretical risks and the compensation for taking over of the risks. Only if this balance is distorted, it may be much more attractive (or less attractive - depending on the situation) to relocate the income related to the taking over of risks to another state. I will go into more detail regarding that aspect below. However, under the assumption that a balance exists between the theoretical risks and the compensation of the risks, it seems to be less likely that this portion of income is shifted to a low-tax state just because of the positive result which may statistically be achieved by the over-compensation for the willingness to take the risk.

What is true for the investment in bonds is, in principle, equally true for the granting of inter-company loan amounts to other group companies. The interest expenses which have to be charged have to be stipulated based on transfer pricing principles (the arm’s length principle). It is, however, much more difficult to clearly find out the appropriate percentage - compared to corporate bonds or state bonds which are listed publicly. Nonetheless, it is theoretically required to determine an appropriate risk compensation which is related to the debtor and its activities. For example, if parent company A (in state A) structures the financing of the group companies (e.g. in state B) through a subsidiary company C (CFC in state C), the interest payments between companies B and C have to fulfil the arm’s length requirements. If company B is not able to operate successfully in state B and the parent company decides to liquidate the subsidiary company, this will directly affect the inter-company loan C-B. Thus, the losses caused by the default of company B should be taken into consideration in state C (and not directly in state A). In contrast, if the financing is directly provided by the parent company A, the risk compensation included in the interest payment will be subject to tax in state A. Again, a possible default of subsidiary company B should - in this alternative - directly affect the domestic tax base in state A. This is, in the same way as outlined above with respect to the investment in bonds, a consistent and symmetrical approach.

The investment in tangible and intangible assets by the CFC in order to provide these assets to another (group) company by way of licensing agreements, leasing agreements, or similar agreements, is a bit more complex than the investment in bonds or the granting of loan amounts. The risks involved may be slightly different and not necessarily limited to the contract partner. For example, a patent right acquired by the CFC which is provided to the group company B may - after a possible default of company B - still be useable by another company. In this case, the risk may be lower than in the situation where a loan amount is granted to company B in order to purchase the patent right directly (and where the loan amount is not

[17] Amato / Remolona, Das Rätsel der Bonitätsaufschläge, BIZ-Quartalsbericht, December 2003, page 57 et seq. (69, 70).

directly secured by the patent right). Nevertheless, what is important in this context is the fact that a licensing or leasing agreement - or any other similar agreement - also contains an interest component. This interest component contains, similar to the interest payments in case of a loan agreement, a risk compensation element which is related to the capital invested. In my opinion, it is quite obvious that the income which is connected to the risk component - irrespective of whether it is related to investment in bonds, loan amounts, tangible assets and intangible assets - is most likely not the decisive factor for the relocation of income to other (low-tax) jurisdictions. At least, it is not the factor, in my opinion, which makes the relocation particularly attractive. Moreover, the fact that the income related to the risk component and the losses caused by the realisation of the particular risk are linked, requires an anti-avoidance legislation which focuses on a current taxation of this component to take into account the positive *and* negative results and not only to be limited to positive income. This, however, is most certainly less attractive for the Member States which apply such an anti-avoidance regime since the final outcome is not properly predictable. In my opinion, if a Member State taxes the risk component on a current basis, it is equally required to provide for an immediate relief in case of a realisation of the respective risks. For example, if the risk component included in the interest income derived from a corporate bond is attributed to the domestic shareholder on a regular (yearly) basis - and taxed according to the domestic tax system - the Member State should be obliged to provide for an immediate relief if the corporate bond cannot be repaid. Otherwise, the interest income will be taxed year by year and, in the worst case, the default will not have any relief-effect in the state of the shareholder. For this reason, the shareholder should be able, in this particular case, to offset the negative income from the default of the debtor with (other) positive domestic income. This, of course, requires the current income attribution not to be kept separately from the regular income taxation.

9.2.3. Income Related to the Basic Interest Component

It was outlined earlier that the OECD-MTC supports the relocation of income from the state where the income is produced to the intermediate state of the CFC by allocating taxing rights (mainly) based on the principle of residence. It is quite simple to incorporate a CFC with equity and to “transform” the equity into inter-company debts only on the level of the CFC. This is particularly effective if the CFC carries on an activity which requires large amounts of capital investment. This can be financing activities, leasing activities, licensing activities, or similar activities, in which the capital investment is the most substantial part of the activities. The basic interest component is therefore, in my opinion, the *only* factor which may be achieved (and taxed) in the intermediate CFC state without exercising any relevant function in this state and without taking a credit risk. In other words, all other income components - apart from the basic interest component - can only be achieved through the exercising of functions or the taking over of risks. It is, in my opinion, the most mobile and flexible part of the total income. The fact that legal entities are typically considered to be non-transparent separate taxpayers combined with a network of double tax conventions which are based on the OECD-MTC provides for nearly unlimited possibilities of allocating this particular portion of income to the states which are the most attractive from a tax point of view. However, the exclusive right to tax the basic interest component in the residence state of the CFC is neither in line with economic principles nor with equity principles. Moreover, the latter is by no means supported by the idea and the concept of an internal market. An efficient anti-avoidance legislation within the European Union should therefore clearly focus on this particular income component.

9.3. The Elements of an Alternative Concept to CFC Legislation

9.3.1. The Basic Interest Taxation

An alternative concept to the existing CFC regimes in the European Union should be based on the conclusions drawn in the previous chapters and the general principle of the separation of income into the three different components outlined above. In my opinion, an approach which solely focuses on (i) certain ("tainted") activities and (ii) the basic interest component is less burdensome compared to the typical CFC legislation. The reason is that such an approach exactly focuses on the decisive element, namely the interest component which is related to the capital itself, and does not include any other income components in the system of current taxation. In my opinion, this is the only possibility of combining CFC type elements with the concept of an internal market and of improving the efficient allocation of capital among Member States. It is self-evident that the alternative concept must be in line with EU law, especially the basic freedoms stipulated in the TFEU. This requires, in my opinion, a non-discriminatory application to cross-border *and* domestic investments. In the following, I will clarify the important elements of such legislation before going into detail regarding the proposed concept itself.

9.3.2. The Requirement of a Non-Discriminatory Approach

The fact that the current taxation of the basic interest component - under certain circumstances - is in line with the concept of an internal market does not mean that the application can be limited to non-resident companies. It is clear from the previous chapters that the current taxation of income leads to a restriction of the basic freedoms. This should not only be true in case of a complete income allocation but also for the allocation of the basic interest component - and therefore only a part of the total income. In spite of all arguments in favour of such a system it is unlikely that the ECJ, based on the case law outlined in chapters 4 and 8, would accept the current taxation of the basic interest component to be limited to non-resident companies and not to include resident companies. Any argumentation for a justification which is based on the aim of preventing tax avoidance would fail since the proposed alternative system should be applicable to capital investments which are the basis for "real" services and, therefore, cannot offer an escape clause for genuine activities carried on in another state. This would be contrary to the idea and the purpose of the system. The argumentation based on neutrality (or the principle of world-wide taxation) would certainly not be accepted by the ECJ, either. Of course, the argumentation in case of limiting the current taxation to the basic interest component is different compared to a typical CFC case in which the total amount of income (or the total amount of passive or base company income) is attributed to the shareholder. Nonetheless, it seems to me that the ECJ would clearly focus on the different treatment and the fact that tax neutrality might also play a role in a merely domestic context. If this is the case, why should tax neutrality only be of importance in a cross-border situation? The outcome of the ECJ case law shows that an argumentation which is based on the fact that the income tax rates are different in other countries compared to income tax rates in a respective Member State is not accepted as a valid criterion. Moreover, one cannot merely focus on the domestic corporate level without taking into account the fact that there are, of course, tax rate differences between domestic corporations and domestic individual shareholders. Thus, if the basic interest component is not only attributable to legal entities but also to individual shareholders, the principle of neutrality is equally relevant for domestic and foreign investments. In other words, the principle of neutrality is not sufficient to justify the restrictive application of an alternative anti-avoidance legislation which is based on the taxation of the basic interest component and which is limited to non-resident companies. However, the application of an alternative system to resident and non-resident companies in a non-discriminative manner can quite easily lead to the outcome that the administrative burden caused by such legislation goes far beyond of any (positive) anti-avoidance effect. In this regard, one has to keep in mind that it is not only the extension to resident companies but also to non-resident companies (and countries) which were outside of the scope of existing CFC rules because of the tax rate. In order to find a balance between the (positive) anti-avoidance effect and the (negative) additional administrative burden caused by the non-discriminative application of such legislation, it is required, in my opinion, to limit the scope to those activities where the risk of tax avoidance - in the manner described earlier - is relatively high. It is therefore necessary to define, in general, capital intensive activities ("tainted activities") which should be in the focus of an alternative anti-avoidance legislation. In addition, the system itself should provide exemptions from current taxation of income for those situations in which the risk of tax avoidance is reduced. Of course, this has to be made in a non-discriminatory manner as well.

In case of an alternative legislation which targets certain types of investment in a non-discriminatory manner it might be misleading to define the company which carries on such activities as a "controlled foreign company"[18] or "CFC." In the following, however, the latter term will still be used occasionally whenever it is appropriate. Even though it is not unlikely that the activities which mainly focus on the provision of capital and which should finally be within the scope of an alternative anti-avoidance legislation more often come up in low-tax countries than in high-tax countries, the latter countries cannot be excluded from the scope of the legislation. In this respect, the better abbreviation for those activities might be "CSC" -which can be derived from "capital service company." Without any doubt, capital services may theoretically encompass a great number of different types of services, and many of them will not be (and should not be) within the scope of such legislation, but the advantage of a different term is the fact that it neither refers to "control" nor to "foreign" companies. Both aspects cannot be decisive for an alternative concept of a current taxation of income.[19] What is really decisive, however, is the term "capital" since it is provided to another (related or unrelated) party mostly in the form of "services." Of course, there may be a "grey area" regarding the differentiation between services and, for example, sales transactions, but this should not play a significant role. The question whether an alternative legislation should be limited to companies, or whether it may also be applied in case of transparent partnerships and permanent establishments, will be outlined below in some detail. What is clear, however, is the fact that such legislation will be required for all types of non-transparent entities. The reason is that the latter entities provide the possibility of the re-location and sheltering of the basic interest component. Thus, since non-transparent entities will be, in any event, the main target of an alternative anti-

[18] Or "controlled foreign corporation."
[19] At least, this is true as long as "control" is to be understood as having the majority of shares or voting rights.

avoidance legislation it is appropriate, in my opinion, to refer simply to “companies.” Therefore, the term “CSC” will be used in the following to describe a resident or non-resident entity which should be in the focus of an alternative anti-avoidance legislation.

9.3.3. The Separation of Activities

It is obvious that not each and every investment requires a current attribution of income to the shareholder from an anti-avoidance perspective. However, it is equally clear to me that a differentiation based on “active income” and “passive income” is not an appropriate solution. In my opinion, the active-passive differentiation is rather artificial and ignores the fact that any income, irrespective of whether it is marked as active or passive, must finally be produced. Thus, even if an activity - e.g. within a certain group structure - is considered to be a passive activity, it will finally be part of an overall activity which produces “new” income. This might theoretically be different if income between related parties is only “artificially” created and allocated. However, such a situation would have to be considered abusive and, in addition, the profit allocation would most likely not be in line with international transfer pricing principles. Therefore, under the assumption that income is allocated appropriately between related parties based on transfer pricing principles (e.g. the arm’s length principle), each portion of income derived by the parties involved (e.g. on different group levels) is directly or indirectly the result of an “active” activity. Consequently, it does not make any sense, from my perspective, to separate the activities which are directly or indirectly involved in the income producing process - no matter how significant or insignificant they are - into “good” income (typically active income) and “bad” income (typically passive income). Thus, if the aim is to support - as far as possible - the principle of capital import neutrality and to exclude the income actually produced by the CSC from any current taxation, the focus must be on substantial capital investments which are made in the CSC state but which are actually utilised by another party for an income producing activity. Moreover, there must be a strict limitation to the attribution of the basic interest component instead of the attribution of income based on an active-passive differentiation. In the following, the types of activities are outlined in which the core of the activity encompasses the provision of capital to another party, either in the form of financial means or in the form of tangible or intangible property. These activities can be seen as tainted activities which should be in the focus of the proposed basic interest taxation.

9.3.3.1. Financing Activities

Financing activities are certainly among the most mobile business activities. The income which is related to the accompanying service element - and which is physically conducted by CSC personnel in the respective state - is often of minor importance compared to the income element which is related to the interest payments. Depending on the structure, a group finance activity (e.g. cash pooling activity) can be carried out almost automatically and in an extreme case there may be very few persons involved in dealing with substantial financial transfers. In such an extreme case, the interest income may encompass nearly all of the income derived by the CSC. In other cases, the financing activity may be concentrated in a group finance centre which provides different types of services, including cash pooling and re-financing activities. In the latter situation, the service element which is related to personnel in the CSC state may be of more importance, but the income which is related to the provision of capital is usually still the predominant element. In general, the purpose of finance companies is to provide financial means to other (group) companies which, in turn, employ the financial means for an income-producing activity mainly outside of the CSC state. The high degree of mobility and flexibility makes it quite simple for a multinational group to allocate such financing functions to the state where the treatment of the interest income - the main element - is particularly attractive, i.e. where it is taxed at a low rate. It is therefore clear to me that a legislation which focuses on the avoidance of the "clustering" of equity in a particular state mainly for tax reasons must concentrate on capital intensive activities with a significant interest component. In this respect, it is absolutely clear that financing activities must be in the focus of such legislation. This should not only be true for the typical intra-group financing activities but also for portfolio investments in interest-bearing bonds, issued by related and unrelated parties.

9.3.3.2. Licensing Activities

Licensing activities, i.e. the exploitation of intangible property owned by the CSC which is utilised by related or unrelated parties, can be very similar to the mere financing activities. At least, this is the case if the CSC is only interposed in order to acquire the intangible property which is subsequently used by a - predetermined - partner for its own business activities. Here, the main purpose is the investment in the intangible property and the making available of the property to another company - which would otherwise be forced to purchase the intangible property directly (and to refinance the amount of investment). However, the licensing activities can go beyond a mere financing activity. This would be the case, *inter alia*, if the CSC was actively involved in the purchasing of intangible property from third parties and the searching of potential third party customers for the exploitation of those rights. In this case, the service character can be much more important and encompasses a greater part of the overall income derived by the CSC. In any case, the licensing income (or royalty income) contains additional elements compared to the income from financing activities. In addition to the compensation for the services provided (and the coverage of the related expenses) - which can also be seen as the compensation for the entrepreneurial risks - and the compensation for the interest related to the capital invested, it is especially the amortisation of the investment and the maintenance of the investment which must be covered by the licensing (or royalty) payments. The latter two elements are normally not of particular importance in case of mere financing activities. Even though the earlier examinations show that most of the elements should be allocable, from an equity perspective and an economic perspective, to the state where the service company carries on its activities, this is not true for the interest component. However, the importance of the capital investments - and therefore the interest component - makes it necessary that the licensing activities are also in the focus of an alternative anti-avoidance legislation.

9.3.3.3. Leasing and Renting Activities Related to Movable Property

In principle, what is true for licensing activities is equally true for leasing and renting activities. The most important difference is certainly the fact that licensing activities are related to intangible property whereas leasing and renting activities are related to tangible property. Thus, the scope of a service company which focuses on leasing and renting activities might be wider than that of service companies which are solely limited to licensing activities. However, this depends mainly on the activities of the multinational group. For example, in a pharmaceutical group the investment in intangible property may be even more important than the investment in tangible property. Another point which may be of relevance is the fact that licensing payments can be subject to a limited taxation at source in some states - although this is not provided for in Article 12 of the OECD-MTC. The leasing and renting activities which are related to tangible property are subject to tax, based on Article 7 of the OECD-MTC, in the state where the activity is carried on. Thus, as long as no permanent establishment exists in another state, the taxing rights are allocable to the residence state of the CSC. Overall, the fact that the income related to leasing and renting activities may be strongly influenced by substantial capital investments requires, in my opinion, that those activities have to be in the focus of an alternative anti-avoidance approach - in the same way as financing activities and licensing activities.

Another aspect which should be mentioned in this context is the differentiation between ‘finance lease’ and ‘operating lease’. IAS 17 defines finance lease as “*a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred*.”[20] There are specific elements which have to be taken into account for the classification as finance lease.[21] If the examination of the arrangement shows that the lease is to be classified as finance lease, the underlying asset is to be capitalised in the books of the lessee. As a consequence, the lessor shows in his books, from an IAS accounting perspective, a receivable and *not* the underlying asset.[22] Essentially, the lessor still provides services to the lessee, but an important part of the transaction is the transfer of an asset. The subsequent payments of the lessee have to be separated into an amount which relates to the reduction of the outstanding liability of the lessee and an amount which relates to the finance charge.[23] In contrast to a finance lease, an operating lease is a (pure) service arrangement which does not result in a transfer of the underlying asset.[24] Thus, depending on the leasing arrangement, the accounting consequences are quite different. The IAS/IFRS rules are one example, but countries may have similar rules under local GAAP and / or tax law which provide for comparable separations of the payments.[25] It is obvious that both arrangements - finance lease and operating lease - have to be, in principle, covered by the respective legislation.[26]

9.3.3.4. Leasing and Renting Activities Related to Immovable Property

The leasing and renting activities which are related to immovable property can be even more capital intensive than the investment in movable property. Thus, there is - in principle - no reason to qualify those services differently from the aforementioned services. However, as already outlined in earlier chapters, the taxing rights for the income from immovable property is, based on Article 6 (1) of the OECD-MTC, allocable to the state of source and not to the state of residence of the CSC. This is a result which is, at least as long as it refers to the interest component, in line with the

[20] IAS 17, paragraph 4.
[21] IAS 17, paragraphs 10, 11.
[22] IAS 17, paragraphs 20, 36.
[23] IAS 17, paragraph 25.
[24] IAS 17, paragraphs 4, 33 and 49.
[25] For example, in Germany the tax authorities issued an administrative circular which deals with the separation and the treatment of leasing activities (administrative circular of the Ministry of Finance, dated 19.04.1971 - VI B/2-S 2170-31/1, BStBl. 1971 I page 264).
[26] With respect to a finance lease, this is true for the service element (not for the transfer of property as such).

principles outlined in previous chapters. Hence, there is - in those cases where the double tax conventions are drafted along the lines of the OECD-MTC - no necessity for any current allocation of income to the residence state of the shareholder of the CSC. Of course, in the rather atypical situation of an allocation of taxing rights to the CSC state there is no reason for a different treatment of income from moveable and immovable property. Therefore, a logical approach might be to take into account, in general, the basic interest income from the leasing and renting activities related to immovable property and to provide for an exemption from the current taxation of income if the latter income is subject to a source-based taxation instead of a residence-based taxation.

9.3.3.5. Other Activities Related to Capital Services

Cases may exist in which the activities of the CSC cannot be clearly identified as one of the aforementioned services. However, the activity can be seen, in substance, as the direct or indirect provision of financial means, or the capital investment in tangible or intangible property, which are not utilised for an income-producing activity of the CSC itself, but for an income-producing activity of another party. This does not necessarily need to be considered a (mere) service activity but can also be seen, legally or factually, as a transaction where the ownership of the property is transferred to the contract partner. For example, a “sale and purchase agreement” related to the transfer of property allows the purchaser to pay the amount included in the agreement by instalments over a period of ten years. Let us assume in this example that the agreement itself does not contain any information on interest included in the total amount. It is apparent, though, that such an agreement must nonetheless be separated into the respective elements, including the provision of financial means for a certain period of time, and the latter element has to be within the scope of the CSC legislation.

Thus, the focus must be, in general, on all those services and transactions which contain an interest element related to capital which is not directly or indirectly utilised for an income-producing activity of the CSC. Here, the economic output created by the capital employed is not created in the hands of the CSC, but in the hands of another party.

9.3.3.6. Other Service Activities and Trading Activities

Other service activities - and theoretically also trading activities - which are not to a large extent related to the provision of financial means or the provision of tangible or intangible property for the utilisation by another party should be outside of the scope of an alternative anti-avoidance legislation. In those cases, the capital investments are made for the purpose of creating income by the CSC itself and not by another party. In other words, the CSC produces “new” income by employing capital and personnel and is therefore “responsible” for the economic output. In contrast thereto, the income related to the activities outlined above is to a large extent based on the economic output created by another party. In my opinion, the fact that the activities may be of less significance in the overall context or may be solely provided to related parties is of no particular relevance. As already outlined above, the production of income cannot be separated into “good” and “bad” income based on the significance of the activities or the relationship of the parties involved in the transactions. Of course, the question arises where to draw the line between services which have to be within the scope of the CSC rules because of the large extent of capital services and those which should be outside of the scope of the CSC rules because of the significant extent of other - non-capital service - activities. The latter aspect will be part of the section dealing with the exemption from CSC taxation.[27]

9.3.3.7. The Combination of Different Activities

It may be the case that the CSC carries on different types of activities and that the aforementioned tainted activities are accompanied by other - non-tainted - activities. In this case, a differentiation and separation between tainted and non-tainted activities is necessary in order to identify the basic interest component of the tainted activities. In any event, the extent of tainted activities carried on by the CSC cannot lead to an “infection” of the non-tainted activities. There is no need to change the classification of the activity just because of the fact that the CSC combines different activities within a single entity. This is a logical approach, in my opinion, if the system is not only based on the separation according to the type of income but also on the separation of income components (horizontal and vertical separation). The alternative anti-avoidance legislation must therefore provide for the possibility of a proper determination of the basic interest component.

9.3.4. The Role of Transfer Pricing Principles

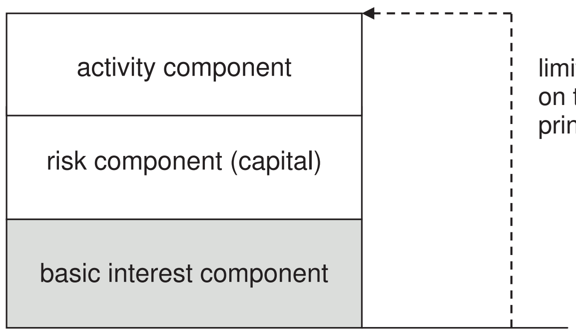
It is obvious from the examinations made in previous chapters that transfer pricing rules cannot be a substitute for CFC legislation or comparable measures. The reason is that transfer pricing rules, in substance, focus on appropriate income allocation among related parties - based on the arm’s length principle - in order to ensure that the parties involved receive a compensation (or receive a profit share) which is comparable to those in a third party relationship. The transfer pricing rules therefore mainly concentrate on the transactions itself and do not deal with the subsequent utilisation of income (only to the extent that the income is again utilised for the generation of new income - and is therefore again part of a transaction). However, the question whether the income, once earned, may be distributed to the shareholder or retained on the level of the corporation is usually not an issue which is of importance from a transfer pricing perspective. The same is true for the question whether the taxing rights for a specific part of the income should be allocable - from an equity perspective or an economic perspective - to another state. Hence, if the services provided by the CSC to related parties are remunerated appropriately, i.e. in the same way as in case of unrelated parties, the transfer pricing requirements are fulfilled.

Nonetheless, transfer pricing rules are of utmost importance as a supporting element for an alternative anti-avoidance legislation. The theoretical non-existence of transfer pricing rules - and in particular the arm’s length principle - would most likely have the effect that multinational groups would try to allocate a higher portion of income to low-tax states to the detriment of high-tax states. Clearly, an approach which focuses on the total and current allocation of foreign income neutralises such an effect. However, even the far-reaching existing CFC rules cannot completely compensate the effect of the (theoretical) non-existence of transfer pricing rules. The reason is that the CFC rules which follow a transactional approach focus on “passive” income. This,

[27] Section 9.4.10.

however, would still provide the possibility of shifting "active" income, based on incorrect transfer prices, to low-tax states. Similar aspects would apply in case of an entity approach: it would either lead to a complete allocation of CFC income, which would neutralise the effect of profit shifting, or to a complete exemption from CFC taxation ("all-or-nothing"). In the latter case, the non-existence of transfer pricing rules would strongly support the profit shifting. It is therefore absolutely clear that transfer pricing principles support any anti-avoidance legislation, especially by providing a limitation for the income which may be shifted incorrectly to another state.

Figure 1:



Of course, this is also true for an alternative anti-avoidance legislation which is concentrated on the taxation of the basic interest component. It was already stated earlier that there can be a correlation between the complexity of functions and the portion of profit (or compensation) allocable to these functions. The higher the complexity, the more likely it is that the arm's length profit share increases. In contrast, a rather simple and less complex function should lead to a lower profit share (or compensation). This should be true as long as it refers to the economic output created by personnel. Similar aspects apply to the taking over of risks: the higher the risks involved, the higher the premium which should cover these risks. In case of capital investments, it may be assumed that the interest component and the amortisation of the investments find expression in the prices for the services provided. Clearly, it may be the case that market prices exist which can make it impossible to allocate all of the cost components to the customers. However, in general, the supplier of services should be in a position - at least in the long run - to determine prices which cover all cost components and the entrepreneurial risks. What is important here is the fact that the economic output created in an inter-company relationship is subject to verifications based on transfer pricing principles. Thus, the simple and less complex functions - which are usually easier to relocate to other states - can only lead to a relatively minor shifting of profits from one state to another. This is a clear and "natural" limitation provided by transfer pricing principles and requires, from my perspective, no additional support from any specific anti-avoidance legislation. Therefore, if a company decides to relocate such inter-company functions and to produce the respective income in another state, the income allocable to the latter state should be limited to the arm's length portion of income. However, the profit which can be shifted to another state can be substantially increased by providing capital services or capital intensive services. The reason is that the arm's length considerations require a compensation for the capital invested or granted. The higher the capital provided, the higher the compensation. The rather simple and less complex functions can therefore lead to high profit allocations if substantial amounts of capital are involved. Also in this case, the transfer pricing rules can have a restrictive effect, but they cannot (and basically should not) avoid - as already stated above - that an arm's length interest component is allocable to the state of the service company, just because of the fact that a substantial amount of capital is invested or granted.

9.3.5. The Separation of Income

Under the existing CFC rules it is in most cases the actual amount of income (in case of the transactional approach it is the actual amount of tainted income) which is determined according to the tax legislation of the state which applies the CFC rules. This leads to the result that - once determined as allocable CFC income - all of the income components are subject to domestic taxation, i.e. a vertical separation of income does not take place. I have already outlined earlier that, in my opinion, such an approach is neither in line with equity and economic principles, nor with the idea and the concept of an internal market. In my view, the latter aspects require a current allocation to be strictly limited to the income component which is not produced by the CFC and which may otherwise, i.e. without a current taxation, attract capital in a non-efficient manner. However, one of the decisive questions is how to separate the income component which should be taxed on a current basis from those income components which should be outside of the system of current taxation.

9.3.5.1. The Basic Interest Component

9.3.5.1.1. General Aspects

Based on the earlier examinations, the basic interest component can be seen as the element which may be achieved by the investor as a minimum compensation, i.e. an investment without taking any relevant credit risks and any additional inflation and liquidity risks. The separation of the basic interest component from the other components could be made by a (separate) valuation of all components included in the income stream of the CSC, or by calculating a certain percentage on the amount of capital which is provided by the CSC to another party. The first alternative, i.e. the valuation of all of the separate components, would be, in my opinion, a quite complicated and unpractical approach. It presupposes that the separate components can be properly estimated and the basic interest component can be identified appropriately. However, such an approach would only partially be supported by transfer pricing principles since those rules typically focus on the total amount of income related to a certain transaction and not on the single income components included. Hence, I do not think that such an approach can be an appropriate basis for an alternative anti-avoidance legislation, especially if the system is to be structured as simple as possible and is not to be more complicated than the existing CFC regimes. The second alternative, i.e. the calculation of a certain percentage on the amount of capital investment, "ignores" the other components. In principle, such an approach avoids any complicated separation of income but requires the determination of an interest rate which reflects the basic interest component. In this case, an appropriate benchmark is required.

9.3.5.1.2. The Appropriate Benchmark

Pursuant to the definition stipulated in previous chapters, the basic interest component should encompass the actual real interest rate and the actual inflation rate on a "rolling" basis, i.e. on the basis of permanent adjustments. The basic interest component should therefore not encompass credit risks, liquidity risks and expectations related to the future development of interest and inflation rates. If the basic interest component shall be the decisive element for a current taxation of income, it is important to clarify how - and on which basis - the component can be established. From my perspective, there are different possibilities to create a link between the basic interest rate (as a rate for the current attribution of income) and an existing market rate.

a.) Short-term state bonds with highest rating category

One possibility can be the reference to the yield of short-term state bonds with the highest rating category within the investment grade. This would be a short-term rating of, for example, A-1+ (Standard & Poor's), F1+ (Fitch) and P-1 (Moody's) as well as a long-term rating of AAA (Standard & Poor's / Fitch) and Aaa (Moody's), respectively.[28] Of course, even the highest rating category is not completely free of any risk and irrational market developments.[29] The influence of irrational market developments can be reduced if the rate is not determined on a specific day, but is determined as an average of a certain period (e.g. month) and, in addition, is linked to an index instead of a concrete (single) state bond. The latter would also avoid, or at least reduce, any effects of (possible) illiquidity.

b.) Interbank money-market rates

Another possibility can be the link to interbank money-market rates, such as the Euribor (Euro Interbank Offered Rate).[30] The Euribor is the rate at which euro interbank term deposits within the euro zone are offered by one prime bank to another prime bank. The banks which are included in the Euribor panel must be banks of first class credit standing, high ethical standards and excellent reputation.[31] The Euribor is determined on a daily basis[32] and contains a significant number of quotes. For the determination of the rate, the highest and lowest 15 percent of the quotes are eliminated and the remaining quotes will be averaged and rounded to three decimal places. The offers (quotes) are made for one to three weeks and one

[28] See with respect to the different categories of the major rating agencies in the internet: http://www.standardandpoors.com, http://www.fitchratings.com and http://www.moodys.com.

[29] The risk in the highest rating category is substantially reduced but not completely eliminated. There is always a potential risk that the (economic) situation becomes worse with the effect that the rating of a given state will be downgraded. The latter, of course, results in an increase in interest spreads (higher risks) and may lead to market irritations. The most prominent examples from the recent past in Europe are Spain, Portugal and Greece (see Bloomberg, Spain's Rating Downgraded to Aa2 by Moody's Over Bank Cost Concerns, March 10, 2011; BBC News - Business, Portugal Hit by Debt Downgrade from Ratings Agency, March 16, 2011; The Guardian, Financial Markets Tumble After Fitch Downgrades Greece's Credit Rating, December 8, 2009; Reuters, S&P Downgrades Greece Rating, Says May Cut Again, March 29, 2011.). Even the United States of America are affected by discussions and announcements with respect to a potential downgrade in the future (see Money Morning, Does the United States Still Deserve its "AAA" Credit Rating?, April 11, 2011; The Washington Post, Standard & Poor's Financial Storm Warning, April 19, 2011).

[30] See in this respect also http://www.euribor.org.

[31] See article 1 of the Euribor Code of Conduct.

[32] Of course, with the exception of weekends and bank holidays.

to twelve months. Based on the daily rates, a monthly average (based on the daily rates) will be calculated and determined as well. The Euribor has the advantage that a high number of quotes are included and the rate therefore reflects - to the greatest possible extent - the market conditions. Moreover, the risks involved in the rates for one to three weeks are substantially reduced. However, it is clear that the rates are not completely free of risks and should, therefore, be slightly higher, in average, than the rates which are based on an index of highest quality state bonds with a comparable term.

c.) Basic rates of the European Central Bank

In principle, it is also possible to refer to one of the basic rates determined by the European Central Bank, i.e. the *main refinancing operations minimum bid rate, the marginal lending facility* or *the deposit facility*.[33] The main disadvantage of the rates determined by the European Central Bank is the fact that the rates are not determined on a daily basis, but on a less regular basis.[34]

d.) Solution

It is important to bring together the requirements based on economic and equity principles and the anti-avoidance aspects - also with respect to practicability. It would be hardly manageable to determine the rate for the current taxation of income on a daily or weekly basis. Even the monthly determination would be quite unpractical. Here, I think it would make more sense to make a "compromise" and to determine the rate in advance for the whole financial year. This means, however, that the rate which is based on such a compromise must include some expectations, e.g. with respect to the development of the interest and inflation rate.

In my opinion, a practical approach could be the focus on the 12 months Euribor which is determined, as an average, for the month preceding the financial year for which the basic interest rate should be applicable. For example, if the financial year is equal to the calendar year, the average rate of the month of December will be applicable for the whole subsequent financial year. The Euribor rate has the advantage that it is based on a substantial number of quotes - and reflects therefore the market interest rate. Moreover, the Euribor is often used, in practice, as a basis for the determination of interest rates in loan agreements and similar agreements. For this reason, it seems to me that such an approach does not give away too much from the basic economic and equity principles and, at the same time, retains the elements of an efficient anti-avoidance (anti-deferral) legislation.

9.3.5.2. The Risk Component (Related to the Capital Investment)

The income which is related to the risk component is certainly a difficult element from an anti-avoidance perspective. The problem lies in the fact that the income which is related to the risk component should be exempt from any current taxation in the state of the shareholder if an actual risk is taken over by the CSC which must be compensated for. However, if the situation is just artificial, i.e. merely created for the

[33] See the ECB website for further details (www.ecb.int).
[34] The frequency of historical interest rate adjustments is presented on the aforementioned ECB website. The number of adjustments per year (and category) in the period 1999-2010 ranges from only one adjustment to seven adjustments.

purpose of earning positive income in the CSC state without any genuine risk for the CSC, there would be no necessity to provide for an exclusive taxation in the CSC state. In this respect, I am referring to the fact that other group companies (in a multinational structure) may step in to take over the risk if it turns out that the risk becomes reality and before it leads to losses of the CSC. From a tax planning perspective it can, of course, be attractive to earn the positive income in the low-tax state and to deduct the negative income from the tax base in the high-tax state. The difficulty is - from an anti-avoidance perspective - that it is unclear whether the group follows such a *plan* of relieving the CSC from the potential risk until a restructuring takes place and the risk becomes reality. For this reason, it is quite obvious that the state which applies a CSC regime has to have an accompanying transfer pricing legislation and other legislation which avoid a situation which allows the taxpayers to replace functions and transfer risks without triggering the corresponding tax implications.[35] To put it more precisely, if - for example - a domestic group company replaces the non-resident CSC - which acts as a finance company (loan provider) - in a situation in which the borrower comes into financial difficulties, it is apparent that the transfer has to be made on an arm's length basis. This should lead to the consequence that the transfer does not only have to be compensated appropriately (e.g. guarantee payments, increased interest rates) but, depending on the situation, might even result in a non-deductibility of the subsequent losses in case of a default. Again, these are flanking transfer pricing and anti-avoidance measures in order to prevent the undermining of the CSC regime (and other domestic legislation).

9.3.5.3. The Activity Component (Related to the Services)

Based on the earlier examinations, there is no reason whatsoever for a current attribution of the portion of income to the shareholder which is related to an activity physically conducted in the state of the CSC. This was already outlined above in some detail. A concept which is limited to the current taxation of the basic interest component provides, essentially, for the possibility of taxing the risk component related to the capital investment and the income related to the service activity in the state where the activity is carried on and not - on a current basis - in the state of the shareholder in the CSC.

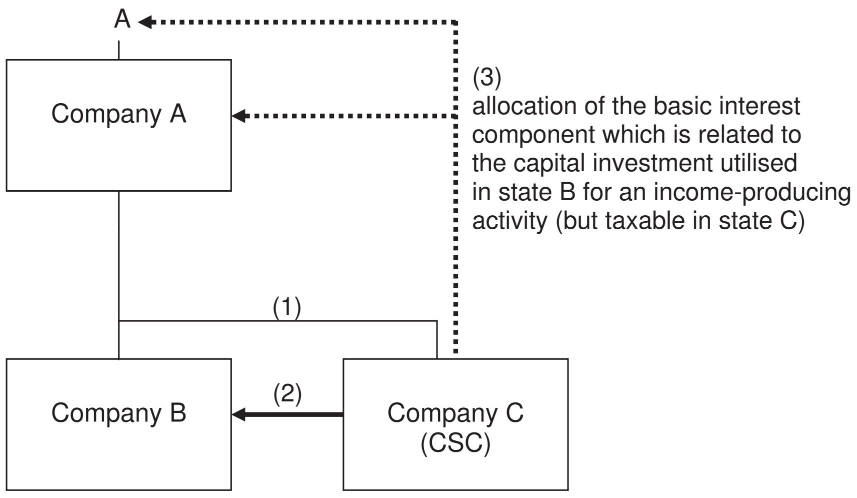
9.3.6. The Taxpayers Subject to Current Taxation of Income

An important question which has to be clarified is the question to *whom* the income should be currently attributed. In general, the existing CFC rules most often attribute the income to the lowest domestic (group) level, i.e. not necessarily to the individual (ultimate) domestic shareholder but rather to the domestic subsidiary company which holds the shares in the CFC directly or indirectly through the interposition of other non-resident companies. In those cases, the domestic legal entity leads to a kind of "sheltering" from immediate taxation in the hands of the individual shareholder. Of course, from an anti-avoidance perspective one could take the position that it is sufficient to attribute the income to the domestic legal entity in order to ensure that it is taxed according to domestic tax rules and that the domestic corporate income tax rate is imposed on the respective income. In this case, the subsequent taxation on the level of the individual shareholder solely depends on the decision of the distribution of the retained earnings to the resident shareholder. However, such an

[35] This is equally true for the application of a CFC regime.

approach overlooks the fact that the basic interest component is - by definition - strongly connected to the capital investments made by the different shareholders on the different group levels. It is obvious, especially from an equity perspective, that an alternative anti-avoidance legislation should focus on the ultimate domestic shareholder and should by no means be restricted to the direct shareholder. Such an approach encompasses, therefore, the individual shareholders and the corporate shareholders (e.g. if the shareholders of the legal entity are non-residents) as well as permanent establishments (in case the shares are allocable to the domestic permanent establishment) and partnerships. Essentially, such a system allocates the risk-free interest component to the *ultimate domestic shareholder* within a chain of corporations or a chain of corporations and individuals (or partnerships).[36] It is as if the domestic taxpayer had granted the capital investment (in whatever form) directly to the respective recipient of the services, but without taking any additional risks. This is exactly what the system wants to achieve: the taxation of the basic interest component - nothing more, nothing less. All of the other income elements should be taxable on the lower levels - either where they are produced or where the risk is taken directly (i.e. has the direct "tax effect"). In principle, it is not relevant how many (group) levels are interposed between the shareholder who is subject to the current taxation of income and the legal entity which derives the tainted income. The uninterrupted application to all (domestic) participants in the line of shareholding ensures the optimal effect from an anti-avoidance perspective.[37] This will be illustrated below where the credit system is outlined in detail. Moreover, such an approach may be of particular importance if permanent establishments and partnerships are involved. This will be outlined below, too.

Figure 2:



[36] The details will be outlined later on, e.g. the question of minimum requirements.
[37] If the requirements are fulfilled, e.g. the percentage of shareholding.

Explanations:

(1) Indirect shareholding of individual A in companies B and C (through intermediate companies).
(2) Financing, leasing, renting and / or licensing services provided by company C to company B.
(3) Allocation of the basic interest component.

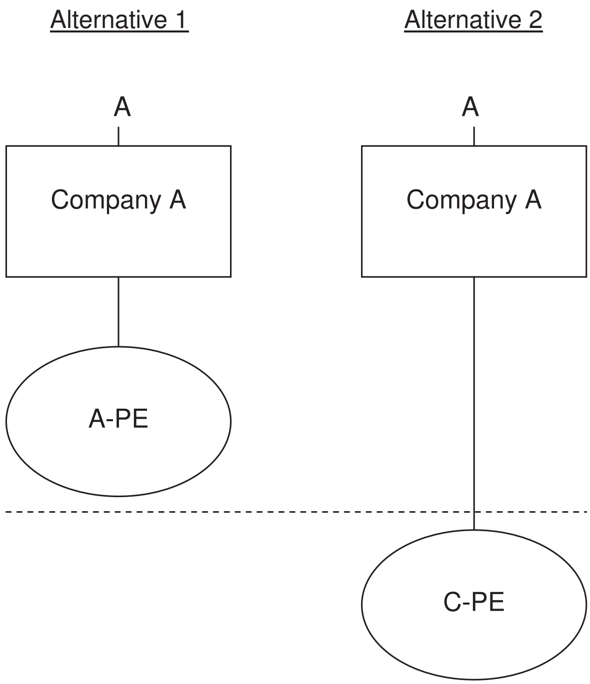
If the basic interest income is generally allocable to the ultimate domestic - individual or juridical - taxpayer, it does not make any difference whether the participation in the CSC is held directly through the individual shareholder A or indirectly through the interposition of resident or non-resident legal entities. Theoretically, if the participation in the CSC is held through a domestic permanent establishment of a non-resident individual or non-resident corporation, the income may also be allocable to the domestic permanent establishment.

9.3.7. The Application to Permanent Establishments and Transparent Entities?

It is obvious that any type of "anti-deferral" legislation (CFC regimes or alternative anti-avoidance legislation) should foremost concentrate on legal entities which provide the possibility of sheltering the income derived from tainted activities. Apart from possible classification conflicts, it is a common approach that legal entities are considered separate taxpayers and are therefore non-transparent for income tax purposes. In contrast thereto, the treatment of income which is derived directly through the domestic taxpayer in another state is dependent on several factors. An effect which is similar to the sheltering of income may only be achieved if the income is derived through a permanent establishment (or transparent partnership), i.e. is actually attributable to the PE (or transparent PS), *and* the exemption method is applied for the avoidance of double taxation instead of the credit method. The latter method would, of course, have the effect of an immediate taxation of the tainted income according to the tax rules and the tax rate of the state of residence. It was outlined in previous chapters that the allocation of tainted property to the foreign PE can be more difficult than the allocation to a separate legal entity. This is particularly true for tainted activities which might be seen as "core functions" of the head office if the residence state does not agree with the allocation to the foreign PE. However, even if the tainted property is allocated to the PE, the income may be taxed in the residence state either under the regular system (e.g. in the United Kingdom) or based on domestic or treaty rules which require a switch-over from the exemption method to the credit method under certain circumstances (e.g. the activity clauses in the German double tax conventions).[38] The avoidance aspect in case of permanent establishments (and transparent partnerships) can therefore be less important - at least in some of the Member States - compared to the investment in legal entities. This, however, is only true as long as it is the domestic taxpayer who (directly) carries on an activity which leads to a permanent establishment or who (directly) participates in a transparent partnership. In contrast thereto, the PE/PS of a subsidiary company, i.e. of a different taxpayer, may create similar anti-avoidance concerns like the investment in a legal entity (without PE/PS).

[38] With respect to the German activity clauses see, *inter alia*, Wassermeyer, Der Wirrwarr mit den Aktivitätsklauseln im deutschen Abkommensrecht, Internationales Steuerrecht 2000, page 65 et seq.

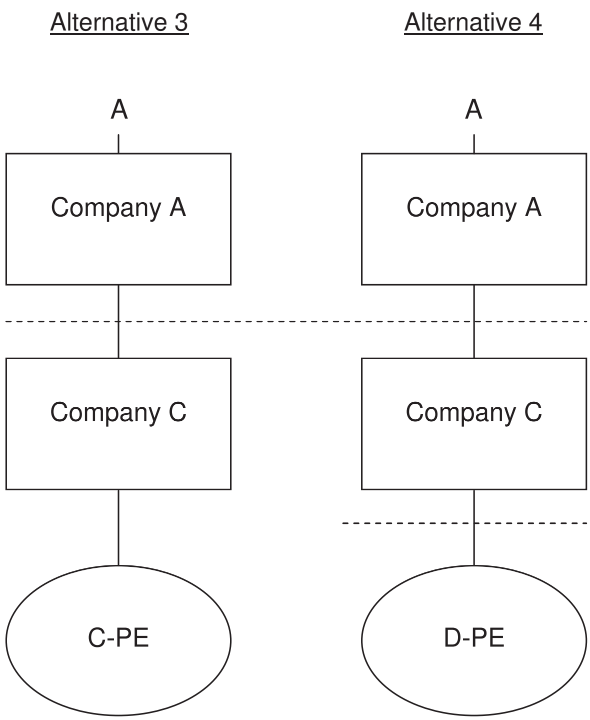
Figure 3:



From the perspective of company A, the purely domestic situation (alternative 1) normally leads to a consolidated taxation of company A which encompasses the income of the company including the portion which is derived through the permanent establishment - at least for corporate income tax purposes. The cross-border constellation (alternative 2) strongly depends, as described above, on the general approach of state A regarding the allocation of tainted property (and therefore tainted income) and the method of eliminating double taxation. If state A applies the credit method for the avoidance of double taxation, the income of the PE will be subject to domestic taxation. In contrast thereto, if state A accepts the allocation of tainted property to the other state *and* applies the exemption method for the avoidance of double taxation, the effect would be similar to the sheltering of income in case of a separate legal entity. If the exemption of income in the latter situation is based on the double tax convention concluded between state A and state C, any attribution of income to the first-mentioned state based on specific domestic (anti-avoidance) legislation - which basically leads to the (partial) application of the credit method instead of the exemption method - would not be in line with the respective double tax convention and would finally result in a tax treaty override. In my opinion, this would not only be true for the actual (tainted) income derived by the PE but would be equally relevant for any basic interest component which, essentially, represents part of the total income derived by the PE. In general, the argumentation for the application of the basic interest approach and the principles outlined in previous chapters are equally important in case of tainted activities which are carried on by a

PE (or a transparent PS). Nevertheless, such an approach must find expression in the respective double tax conventions and should not unilaterally be implemented as an exception to the exemption of income. Overall, it may be concluded that even though economic and equity principles support the application of the basic interest taxation in the aforementioned situations, there is, in principle, the requirement of a stipulation of such legislation in the respective tax treaties.

Figure 4:



In this example, a subsidiary company (company C) is interposed between company A and the PE in state C (alternative 3) and state D (alternative 4), respectively. This is an important deviation from the previous example since company A and company C are different taxpayers. Here, the activities carried on through the PE in state C and state D are connected to company C and are, therefore, separated from company A. The non-identity of the taxpayers opens the possibility for the application of the basic interest taxation to the tainted activities of company C - with or without a PE - and normally without any infringement of the double tax convention concluded between the two states.[39] In other words, the basic interest component connected to the tainted activities of company C in state C and state D may be subject to current allocation to the shareholders in state A. Of course, the procedure may be more difficult if the tainted activity is split over two different states (alternative 4), but this

[39] See chapter 7.

should not be examined in further detail at this point in time since the practical aspects of such a legislation will be outlined below.

From the perspective of the individual shareholder A, the activities carried on through the PE are in all four alternatives connected to separate taxpayers, namely company A (alternatives 1 and 2) and company C (alternatives 3 and 4). Therefore, if an alternative anti-avoidance legislation not only focuses on the direct shareholder in the resident or non-resident company which carries on the tainted activities, but also on the indirect shareholder, there should not be an obstacle for an income allocation caused by the double tax convention concluded between state A and state C. Thus, a basic interest taxation which is based on the tainted activity of company A and its PE activities in state C (alternative 2) should not result in a tax treaty override as long as the allocation is limited to the individual shareholder A (a separate taxpayer) and does not encompass company A (one and the same taxpayer). Therefore, it can be concluded that the strict focus on legal entities should also encompass the activities of these legal entities carried on by permanent establishments - irrespective of the group level. In the alternatives above, this ensures a consistent allocation of the basic interest component to the individual shareholder A (in all four alternatives) and to company A (in alternatives 3 and 4). Hence, what must be excluded from the current allocation to the shareholder is the income which is explicitly exempt from domestic taxation on the basis of a double tax convention. This prevents state A from taxing the income of the permanent establishment in the hands of company A in alternative 2. Overall, it can be concluded that the inclusion of the indirect (ultimate) domestic shareholder in the basic interest taxation extends the application of the anti-avoidance approach to “indirect” permanent establishments and the indirect participation in transparent entities. This ensures that constellations are covered by the proposed anti-avoidance legislation which can have a comparable effect like the “income sheltering” of legal entities, but without resulting in an infringement of the double tax conventions (tax treaty override).

9.3.8. The Percentage of Voting Rights or Shareholding

On the one hand, it is clear from the previous chapters that there is no need from an economic and equity perspective to provide for a certain minimum participation in order to apply a system which is based on the current taxation of the basic interest component. On the other hand, it seems that it is not necessarily required from an anti-avoidance perspective nor feasible from an administrative perspective to allocate the basic interest component to each and every shareholder, no matter how small the percentage of participation in the company actually is. Of course, a certain minimum percentage of voting rights or shareholding opens the possibility of avoiding the application of the rules by holding a percentage slightly below the threshold. For this reason, it is important to find a balance between a minimum threshold from an anti-avoidance perspective and the acceptable threshold from an administrative perspective.

9.3.8.1. The Majority Voting Rights or Shareholding

The requirement of majority voting rights or, alternatively, majority shareholding is certainly the “maximum threshold,” i.e. there is - at least from my perspective - no reason to apply a higher threshold than a majority threshold. A shareholder with voting rights of more than 50 percent has a decisive influence on the company. He is in a position - if necessary against the votes of all other shareholders - to decide on the management of the company and therefore influence the business activities. He may have access to all the information related to the company and its activities and can decide whether the company distributes its profits to the shareholders or not. For this reason, it is apparent from an anti-avoidance perspective that the shareholder with voting rights of more than 50 percent should be subject to current taxation.[40] If the percentage of voting rights differs from the percentage of shareholding in a way that only the shareholding is more than 50 percent (and the voting rights are equal to 50 percent or less than 50 percent), this should be equally sufficient for the question of income allocation. Even though the shareholder has, in this particular situation, not the same degree of influence, the majority in the equity of the company reflects a substantial capital investment (in relation to the overall investment). Essentially, it is the capital investment which is the basis for earning the risk-free interest component and it should therefore be considered to be an equally important factor - despite the limited influence in this situation. The problem is, however, that such a high threshold provides more possibilities of avoiding the application of the anti-avoidance rules, e.g. by splitting the shareholding 50:50 with another party. Of course, international groups would prefer to have wholly owned subsidiary service companies instead of joint ventures with unrelated parties for the provision of financial or other services. The majority requirement would therefore certainly encompass a substantial number of investments. However, the existing CFC rules within the European Union show that the majority requirement is rather exceptional. That means, in most of the Member States there is either a lower threshold or other - alternative - criteria exist which may trigger the application of the respective CFC rules.[41]

9.3.8.2. The Non-Majority Voting Rights or Shareholding

In principle, there is a difference between 50 percent voting rights (or shareholding) and a percentage below 50 percent. The 50 percent threshold requires a consensus between two 50:50 shareholders (or a particular group of shareholders) and therefore confers a more important position than minority rights, i.e. a percentage below 50 percent. However, the 50 percent shareholder cannot - under all circumstances - enforce his position. The influence itself naturally decreases with the percentage of voting rights (and / or shareholding) in the company. Any percentage which is below 50 percent allows, theoretically, that another shareholder (or a particular group of shareholders) may act - at least to a certain extent - against the position of the minority shareholder. However, the question is whether this is of any significance for the current taxation of income. In contrast to the existing CFC rules, the proposed alternative legislation will be applicable, if certain conditions are fulfilled, to income which is derived by resident and non-resident companies. The restrictive effect which may be caused by the allocation of income is therefore equally burdensome for shareholders in resident and non-resident companies. This is, as described separately, an important prerequisite from an EU law perspective. In addition, the focus on the basic interest component - instead of passive income, base company income et cetera - should be in line with the ability-to-pay principle as well. However,

[40] In this case it is required, though, that there is *any* interest in the respective entity (taking into account also constructive ownership rules). Clearly, in case of more than 50 percent voting rights it is rather unlikely that there is no (direct or indirect) interest in the respective entity. But from a theoretical standpoint the current taxation of income requires an interest in the CSC (otherwise no capital would be invested by the respective person which produces an interest component and which could be allocated to this person).
[41] See chapter 6 for more details to the ownership requirement in the Member States.

the fact that the income allocation is based on property of a different legal entity and different taxpayer requires the shareholder - in order to submit the required information (via tax return) and to calculate the respective tax base - to be in a position to gather this information. If the respective shareholder just holds a few shares among hundreds or thousands of other shareholders, it may be difficult to receive the information. In such a case, it is questionable whether the aim pursued with such legislation and the burden for the taxpayer to gather the required details for the determination of the tax base (including the compliance costs) is in an acceptable relation, i.e. whether it is proportionate. If the taxpayer is unable to gather the necessary information, the tax administration itself will finally have to apply for an information exchange with the other Member State in which the non-resident legal entity carries on its activities (or, in a domestic context, with the tax office responsible for the resident legal entity). Otherwise, the taxpayer or the tax authorities would have to make an estimation of the taxable income which, of course, cannot be an acceptable result.

Therefore, the threshold should be high enough to find an appropriate balance between the obligations of the taxpayers and the interest of the Member State to tax part of the income on a current basis. The earlier examinations show that the threshold of the existing CFC rules varies considerably, but is in most cases - related to a single shareholder or a group of related shareholders - clearly below 50 percent.[42] A threshold for the application of CFC rules which is often applied in the Member States is 10 percent and 25 percent.[43] This may also be dependent on the respective company law. At least, the latter percentage may provide the possibility of blocking decisions of great importance and can therefore be seen as a significant participation.[44] Even a participation of 10 percent may in some Member States confer rights which exceed those of shareholders with a lower participation and which are unable to reach the threshold.[45] In my opinion, it is less likely, especially in case of multinational enterprises, that activities are combined in a way that the respective investor holds a percentage of less than 25 percent in a CFC just in order to achieve an advantage which is limited to the deferral of the domestic taxation on the basic interest component. Such a percentage of voting rights or shareholding would definitely limit the influence on the management of the company and the daily business and can hardly be imagined as a widespread structure (just for tax purposes). In this respect, I think that a percentage of 25 percent (voting rights or shareholding) can be an appropriate threshold and an acceptable balance between the necessity of an anti-avoidance legislation and the position of the shareholder. The percentage should be high enough to have influence on the participation and to gather the information required for the taxation of the basic interest component. Moreover, a threshold of 25 percent avoids the application to small and insignificant shareholdings and therefore avoids inappropriate compliance costs and administrative costs which are not proportionate to the aim pursued. The fact that a percentage of 25 percent may be not sufficient to decide on a profit distribution - at

[42] See chapter 6 for more details.
[43] See chapter 6 for more details.
[44] For example, the amendment of the statutes of a German *Aktiengesellschaft* requires a majority of at least three quarters of the voting rights which are present at the shareholders' meeting (§ 179 (2) AktG). The same is true for the increase in the share capital (§ 182 (1) AktG). A participation of 25 percent is therefore sufficient to block important decisions.
[45] For example, the German GmbH-Gesetz confers the right to shareholders with a percentage of at least 10 percent (combined) to request a shareholders' meeting (§ 50 (1) GmbHG).

least not against the position of the majority shareholders - is not decisive in this respect.

9.3.8.3. The Application of a Financial Threshold

The question may be raised whether the 25 percent rule should be the only decisive threshold in situations in which the shareholder invested a substantial amount of capital in the company but without holding the required percentage of shares. Clearly, the actual influence (not necessarily the legal influence) achieved by an investment of 10,000,000 Euro is most likely greater than in case of an investment of 10,000 Euro, even if the percentage of shareholding may be the same in both cases.[46] The same is true for the effect of such an investment in a low-tax state (or even a tax haven). The financial advantage of sheltering (interest) income which is related to 10,000,000 Euro of capital investment is, of course, much greater than in case of 10,000 Euro of capital investment. One might be tempted to agree that the amount of investment - and not only the percentage of investment - should have an influence on the decision whether or not the tainted activity should be subject to current taxation. However, it should not be overlooked that any actual influence which may be achieved by a higher amount of investment cannot really be measured appropriately. It has always to be seen in the overall context. The aforementioned 10,000,000 Euro investment in a publicly listed multinational company may confer less shareholder rights than the 10,000 Euro investment in a small company. However, the possibility of gathering all the necessary information for the application of the proposed alternative anti-avoidance legislation is crucial. The reference to a 25 percent shareholding ensures that the investment of the respective shareholder is always seen in the overall context and clearly reflects a portion of shareholding which may be seen as a relatively important shareholding (irrespective of the absolute amount of shareholding). In my opinion, an alternative legislation should therefore stick to a minimum percentage of shareholding (or alternatively voting rights) and should not apply an alternative - absolute - financial threshold.[47]

9.3.8.4. The Related Parties to the Shareholder

It is obvious that constructive ownership rules are necessary to avoid the circumvention of the application of CSC rules. For this reason, it is necessary to define the parties which are related to a shareholder. The allocation itself can only be made to shareholders, i.e. the persons who have an interest in the CSC (and not only voting rights). However, for the determination of the degree of (direct and indirect) influence in the CSC - and therefore the question whether the respective threshold is reached or exceeded - it is important to take into account the parties which are related to a shareholder. Of course, related parties can be individuals as well as juridical persons and do not have to be resident in the state which applies the CSC regime. However, it is not unlikely that the tax law of a given state already provides a definition of what is meant by ‘related parties’ (e.g. in the general tax code) and which may be relevant for a number of different purposes. Moreover, it could also be possible to refer - at least partially - to a definition outside of the tax laws, e.g.

---

[46] For example, if the share capital in the first-mentioned case is 50,000,000 Euro and in the second-mentioned case 50,000 Euro. It will be a shareholding of 20 percent in either case.

[47] In contrast thereto, an absolute amount could be applied for the decision whether the activity should be exempt from current taxation (or not) in order to avoid that minor investments fall within the scope of such legislation (see later on in more detail).

definitions provided by accounting standards. In such a case, it may be possible to (partially) refer to definitions which are already existent. In general, the scope of the 'related parties' for CSC purposes should, in my opinion, encompass the following persons:

a.) Persons who are related through family membership

In case of an individual person it seems to me that members of a family - up to a certain degree - should fall within the definition. This should be the partner (wife, husband, engaged couple, registered partner), the family relatives in straight succession (parents, children, grandchildren, great-grandchildren), the siblings (brothers, sisters), the children of the siblings and the partners of the siblings. It should also include the siblings of the parents as well as foster parents and foster children. More distant relatives should be outside of the definition of 'related parties.' In the aforementioned cases it can be assumed that there is such a close (family) relationship that the influence of the person in question *and* the related persons on the CSC (by voting rights, shareholdings) cannot be seen strictly isolated from each other.

b.) Persons who are related through factual or contractual arrangements

There may be situations in which the shareholder in the CSC has certain factual or contractual arrangements with other individual or juridical persons who hold shares or voting rights in the CSC. If such arrangements determine a decisive influence on the decisions of the other party / parties, it is obvious that in such a case the combined interest in the CSC has to be taken into account for the calculation whether the threshold is reached or exceeded.

c.) Persons who are related through shareholding structures

Based on the previous arguments and conclusions with respect to the appropriate threshold in section 9.3.8.1. and 9.3.8.2., shareholdings and / or voting rights of at least 25 percent shall be decisive for the application of the CSC regime. Later on it will be outlined how the threshold shall be calculated in a group structure where entities are interposed between the (ultimate) shareholder and the CSC and this will, therefore, not be outlined in this context. However, it is clear that the interposition of entities which are (partially) held by persons described under a.) and b.) should result in the same treatment as a direct holding, i.e. the percentage should be calculated by taking into account the related party interest. On the other hand, a participation of 25 percent in an intermediary entity should not automatically result in the aforementioned combined calculation if the remaining participation of 75 percent in the intermediary entity are held by unrelated parties. In other words, the substantial shareholding in an intermediary entity should not be enough to 'infect' the whole entity. However, if the shareholder in the intermediary entity has a decisive influence by way of majority rights (shareholding and / or voting rights), it seems to be necessary - similar to b.) - that the whole shareholding / voting rights of the intermediary entity is part of the percentage calculation to determine whether the threshold is reached or exceeded. In my opinion, it is helpful to set - for this particular purpose - a clear 'majority requirement', because in contrast to the threshold for the allocation of income it is the decisive influence which should be relevant for the classification.[48]

What was outlined above are the ‘related parties’ mainly for the purpose of avoiding the circumvention of CSC taxation and therefore the calculation whether the CSC threshold is reached or exceeded (see also the constructive ownership rules in the following). It may be the case, however, that the definition of ‘related parties’ is also required for other purposes, e.g. when it comes to the exemption provisions. Even though there will be no difference regarding a.) and b.), it can be possible that the requirement under c.) has to be structured differently. To put it more precisely, if there is an exemption from CSC taxation for certain services provided towards *unrelated parties*, it may be necessary to set a different threshold. Instead of being a related party in case of majority interest / voting rights, the threshold could already be set at a lower percentage. Again, this depends very much on the respective provision and the risk of tax avoidance involved.

9.3.8.5. Constructive Ownership Rules

The stipulation of a fixed percentage of shareholding or voting rights requires additional rules in order to avoid the circumvention of such legislation. This is particularly true if the threshold is relatively high. Otherwise, it would be too simple to split the shareholding over certain related parties (e.g. family members) in order to avoid the current taxation of income. For example, if the 100 percent shareholding in company C could be allocated to five family members, all of the shareholders could have a percentage of shareholding (or voting rights) which is below 25 percent. Again, it must be clear that the proposed legislation should not be a penalty for the investment in certain activities, but should only lead to a limited taxation in the state of residence. Equity aspects require, in my opinion, that a circumvention of the proposed legislation should be avoided as much as possible. Of course, this will not always be the case, especially if the (personal or contractual) relationships between shareholders are not disclosed and open for verification. However, the most obvious situations should be targeted by the constructive ownership rules. These are, in my opinion, family relationships and the factual or contractual influence on certain individuals or legal persons. The shareholders must be obliged by law to disclose common shareholdings and contractual arrangements in order to open the possibility of verifying the application of the basic interest taxation. Therefore, if two or more related persons hold shares in a company which carries on tainted activities, and the combined shareholding is at least 25 percent, the shareholding requirement is fulfilled. The question arises whether in such a situation the current attribution of income should be made to each of the related shareholders or whether there should be - an additional - minimum threshold for the income attribution. For example, if each of the two related shareholders A and AA hold directly 24 percent in company C, i.e. together 48 percent, it is rather obvious that the basic interest income should be allocated to both shareholders, 24 percent to A and 24 percent to AA. However, if shareholder A holds 24 percent and shareholder AA holds one percent, the constructive ownership rules should lead to the outcome that the 25 percent

[48] Even though the decisive influence may, depending on the situation, already exist in case of a shareholding which is below a majority shareholding, it is just simpler - for this purpose - to have a clear separation and a clearly defined requirement. For this reason, it is again helpful to focus alternatively on shareholding / voting rights, i.e. if one of the two confers majority influence (majority shareholding or majority voting rights), the requirement is fulfilled.

requirement is fulfilled. The additional question is whether the current income allocation should be limited to shareholder A (24 percent) or whether a current income allocation should also encompass shareholder AA (one percent). At least, it is clear to me that the one percent income allocation cannot be added to shareholder A (which would result in a 25 percent income allocation). This would be, in my opinion, a non-acceptable approach since shareholder A is - although related - not the legal owner of 25 percent but only 24 percent. Thus, the maximum income attribution should be 24 percent. What remains is the question whether one percent of the basic interest income should be attributed to shareholder AA or whether - for administrative reasons - a minimum percentage for the income allocation should be required. From my perspective, I do not see the necessity for such an additional threshold just for the purpose of income attribution. If it turns out - due to the constructive ownership rules - that the general ownership threshold of 25 percent is reached or exceeded, the basic interest income should be allocated to all of the related shareholders - but not (other) unrelated shareholders - irrespective of the actual percentage of shareholding. Such an approach avoids additional possibilities of circumventing the alternative legislation, e.g. by allocating small percentages of shareholding over a great number of related parties, and ensures that the legislation does not become too complex.

9.4. The Anti-Avoidance Concept of Capital Service Company (CSC) Legislation

9.4.1. The Determination of the Basic Interest Rate

Based on the earlier examinations, the basic interest rate for the CSC taxation should be determined once a year, preferably before or right at the beginning of the financial year of the entity which carries on the tainted activities. Following the proposal which was made earlier in this chapter, the rate shall be based on the 12 months Euribor which is determined, as an average, for the month preceding the respective financial year. This rate shall be applicable for the whole financial year.

9.4.2. The Determination of the Tax Base

The proposed alternative approach does not directly focus on the total income derived by the legal entity but only on the basic interest income related to certain property which is made available to the recipients of the services (tainted property). In the following, I will go into detail regarding the determination of the tax base for the calculation of the basic interest component. In this respect, I will start with the description of the system in general before dealing with “mixed” activities, debt financing and the determination of the net calculation basis.

9.4.2.1. The Determination of the Calculation Basis of the Property

The basis for the calculation of the basic interest component is, in general, the total amount of assets which are provided by the legal entity to another party - be it a related or an unrelated party. The assets are not directly employed for an income-producing activity of the legal entity itself but for an activity of another party (tainted property). The assets are related to financing, leasing, renting, licensing or similar activities - as already stipulated above - and encompass tangible and intangible property. In my opinion, there should be a clear and strict separation between tainted and non-tainted property. Only the property which is *directly* made available to another party shall be considered tainted property, but not the assets which are only *indirectly* related to the activities. Such "auxiliary" property is, in general, to be treated as non-tainted property. This simplifies the approach and is, in my opinion, justifiable. For example, the computers, office furniture et cetera which is related to a leasing activity supports directly the activity component and only indirectly the basic interest component. One might even argue that the auxiliary property is not required for earning the interest component, but only for earning the activity component.

It is obvious that the simplest approach in determining the calculation basis is the reference to the balance sheet of the legal entity and the book value of the property (including loan amounts). The basis can be calculated as an average between the book value at the beginning of the financial year (which is the book value at the end of the preceding year) and the end of the financial year. For property which was purchased or sold within the financial year, adjustments have to be made regarding the interest calculation period. That means, for the property which was purchased, for example, at the end of October, the calculation basis is to be determined as the average amount of the purchase price at the end of October and the book value at the end of the year. The interest, however, is only to be calculated for a two-month period (November and December) instead of a twelve-month period.[49] The same principles apply for property which was sold within the financial year. In this case, the interest calculation is to be limited to the period between the beginning of the year and the date of disposal. For simplification reasons, the calculation of the interest might be separated into a twelve-month period, i.e. the calculation starts with the month following the acquisition and ends with the month preceding the disposal of the property. The problem is, however, that the book value of the property does not necessarily reflect the economic lifetime and does not necessarily go hand in hand with the amortisation component included in the payments. For example, if the depreciation period for certain property in the financial statements of the entity is only five years, but the economic lifetime *and* the period of amortisation which underlies the contractual arrangement is ten years, the concentration on the (average) book value would not lead to an appropriate result. In this case, the basic interest calculated on the book value would be too low since the period of capital investment exceeds the period of depreciation in the financial statements.[50] In contrast thereto, if the depreciation period is five years and the amortisation period which underlies the contractual arrangement is five years, too, the period of capital investment and the period of depreciation would be identical. Thus, the interest calculation would be correct, despite the fact that the economic lifetime is ten years. It may be questionable, in the latter example, whether the stipulation of the (e.g. leasing) payments would be in line with transfer pricing principles. It is obvious that the contractual relationships must, first of all, fulfil the arm's length requirement. If this is not the case, income adjustments are necessary. However, even if the payments are not accepted as completely tax deductible in the respective period - due to the fact that, for example, the leasing payments are considered to be too high - there is still an increased cash flow which reduces the overall amount of capital investment in the state of the service company and therefore reduces the basis for the basic interest

[49] Under the assumption that the financial year is equal to the calendar year.
[50] It makes a substantial difference whether a specific asset is depreciated over a period of five years or over a period of ten years when the (average) book value is the basis for the calculation of the basic interest component. A five year straight-line depreciation brings the book value to zero at the end of year five (and therefore the calculation basis is zero after year five) whereas in case of a ten year straight-line depreciation the book value at the end of year five is still 50 percent of the original value.

calculation.[51] However, one should not forget that the possibilities of increasing the deductible expenses, e.g. in the high-tax state, without coming into conflict with transfer-pricing principles are limited. Moreover, it is worth noting that the proposed calculation basis is not identical to the fair market value of - for example - the respective property. The fair market value can be influenced by a number of additional (economic) factors which may result in considerable ups and downs during the lifetime of the property. However, what is important for the determination of the calculation basis in this context is not a 'mark-to-market' value at specific points in time, but a value which reflects, as much as possible, the average amount of capital provided during the contractual period (e.g. through a leasing agreement).

In any event, the difficulties in determining the calculation basis are not completely identical for all types of tainted property. For this reason, the approach will be discussed separately for the different types of activity.

9.4.2.1.1. Financing Activities

The concentration on the book value is certainly a feasible approach for the provision of loan amounts, the investment in bonds and similar types of investment. This is particularly true for long-term loans without any permanent changes of the principal amount. In this case, the calculation basis may simply be derived from the balance sheet of the service company. In case of fixed monthly payments (interest and amortisation), the average amount of outstanding loan amounts can also be determined without much effort. However, it is clear that such fixed payments lead to the result that the amortisation element which is included in the payments increases as soon as the interest element decreases. Thus, the amortisation element at the beginning of the year is lower than at the end of the year. For simplification reasons - and in favour of the taxpayer - it shall be acceptable to consider an average amount which is based on a linear reduction of the loan amount. The situation can become a bit more difficult if a permanent cash transfer takes place (e.g. in case of cash pooling activities). Here, the average outstanding loan amount cannot be derived from the balance sheet, but the tax base must be determined by taking into account the average weighted outstanding amount of loan during the financial year, e.g. by considering the outstanding amount per day. Although this information cannot be derived directly from the financial statements, it can be derived quite easily from the accounting system of the service company.

[51] At least in those cases in which the capital is not reinvested in tainted property. Essentially, what is important in the example is the period and the amount of capital provided by the service company. The higher the amortisation element, the lower the average amount of capital provided during the contractual period. Of course, a lower average amount of capital results in a lower calculation basis for the basic interest component.

Example: the loan account of the financial service company is subject to changes during the year 01. The amounts are in Euro.

Loan account at the beginning of the year 01: 100

Loan balance:	100 (20 days per year)	100 x 20 =	2,000
Loan balance:	300 (50 days per year)	300 x 50 =	15,000
Loan balance:	425 (80 days per year)	425 x 80 =	34,000
Loan balance:	400 (30 days per year)	400 x 30 =	12,000
Loan balance:	500 (90 days per year)	500 x 90 =	45,000
Loan balance:	800 (90 days per year)	800 x 90 =	72,000

Average (weighted) amount during the year 01 (tax base): 180,000 / 360 = 500

Loan account at the end of the year 01: 800

In the example, the basic interest component is to be calculated on the average (weighted) amount of 500 Euro (for the year 01) and is currently allocable to the domestic shareholder in the financial service company.

Extraordinary write-downs on the principal amount which are related to the risk of the debtor cannot have any impact on the calculation basis as long as the contract is still in place and to the extent that the contractual payments does not amortise the capital investment. This is true for all of the aforementioned types of financing. In general, it can be concluded that it is the average amount of book value which has to be taken into account for the determination of the calculation basis - corrected in case of extraordinary adjustments of the book value. With respect to changes in foreign currency, it is appropriate - especially from the perspective of simplification and practicability - to accept a revaluation included in the balance sheet of the CSC.

9.4.2.1.2. Licensing Activities

In general, it can be concluded that the book value is, from a simplification perspective, the ideal calculation basis. The reason is that it can easily be derived form the accounting system of the service company. However, this requires not only that the depreciation which is taken into account is derived from the expected economic lifetime of the property, but also that the value is in line with the amortisation element included in the licensing payments, i.e. the original value reduced by the amortisation payments. The optimal situation can therefore be shown by the following equation:

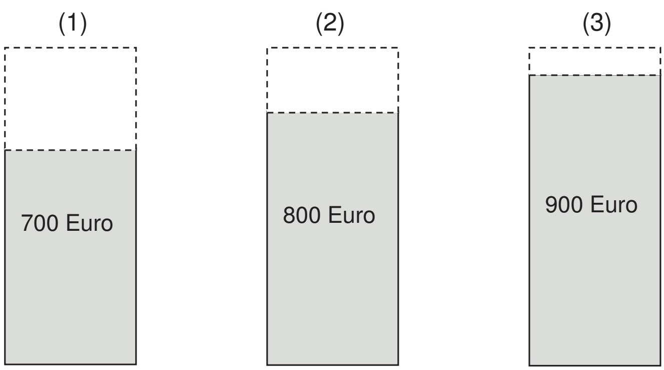
book value = economic value = original value minus amortisation

The problem is, however, that this is often not the case. It is, in particular, the tax depreciation of the property which may deviate from the economic depreciation, e.g. because of increased depreciation rates, declining depreciation, special depreciation rules for tax purposes, et cetera. Moreover, it is the amortisation element which is decisive for the question of how much capital is actually provided to the service recipient during the contractual period and not the book value. However, it can be very difficult to estimate the amortisation element, especially if it is related to intangible property.

For this reason, it seems to be advisable to start with the book value, as the basic element, and to compare the book value with the economic value - and the depreciation based on the expected economic lifetime. If the book value deviates from the economic value, it is necessary to make adjustments in order to end up with the (deviating) economic value. The country which applies the anti-avoidance legislation should focus on its own economic depreciation rates which are based on the expected economic lifetime of the intangible property and which should normally be reflected by "regular" and straight line depreciation. The advantage of such an approach is that the economic depreciation should come closer to any (arm's length) amortisation in a contractual relationship than the tax depreciation in the state of residence of the CSC which can be influenced by a number of other aspects. Nonetheless, it is theoretically necessary to compare the adjusted book value (= economic value) with the original value after taking into account the actual amortisation payments. The latter step, however, is quite an unpractical and difficult approach. For this reason, I propose the subsequent procedure which shall be illustrated by an example:

Example: the acquisition price of the intangible assets was 1,000 Euro. The book value for tax purposes after the first year is 700 Euro (300 Euro of declining depreciation for the first year). The economic value is 800 Euro (200 Euro of theoretical economic depreciation per year). The amortisation component is only 100 Euro.

Figure 5:



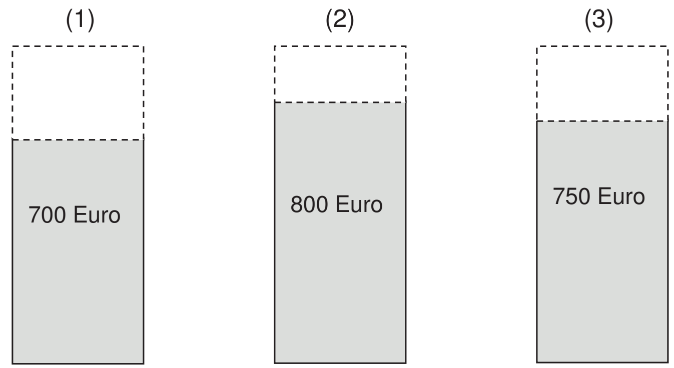
Explanations:

(1) Book value of 700 Euro after one year (300 Euro of depreciation).
(2) Economic value of 800 Euro after one year (200 Euro of theoretical depreciation).
(3) Value of 900 Euro after one year of amortisation (100 Euro of amortisation).

For the determination of the calculation basis it is first required to make an adjustment of the book value for tax purposes and increase the book value to the higher economic value of 800 Euro. The latter value should then be compared to the original value after taking into account the amortisation of 100 Euro - which is a value of 900 Euro. The problem of this second step, however, is that the value after amortisation is not easily available. Of course, it is available, but not as easily as the book value and the economic value, but requires additional information. From a practical point of view it is therefore difficult to rely, in general, on the value after amortisation. From an anti-avoidance perspective it seems to be acceptable, in my opinion, to take into account the basis of 800 Euro instead of 900 Euro. Essentially, the lower amortisation rate has the effect that the income derived by the service provider is lower than it should be - based on the economic value. However, this is only true as long as no additional (deferred) payment is required at the end of the contractual period which compensates for the difference. I will come back to that aspect below in the context of leasing services where such additional payments can play an important role. In other words, it is acceptable, not only from a simplicity perspective but also from an anti-avoidance perspective, to rely on the average economic value - which can be the adjusted average book value of the property - to determine the calculation basis for the basic interest taxation.

Example: the acquisition price of the intangible assets was 1,000 Euro. The book value for tax purposes after the first year is 700 Euro (300 Euro of declining depreciation for the first year). The economic value is 800 Euro (200 Euro of theoretical economic depreciation per year). The amortisation component is 250 Euro.

Figure 6:



Explanations:

(1) Book value of 700 Euro after one year (300 Euro of depreciation).
(2) Economic value of 800 Euro after one year (200 Euro of theoretical depreciation).
(3) Value of 750 Euro after one year of amortisation (250 Euro of amortisation).

In principle, what was outlined above is equally true in this alternative. However, in contrast to the example above, the economic value after one year (800 Euro) is higher than the acquisition value after taking into account the amortisation element (750 Euro). The focus on the economic value can therefore lead to the result that the capital actually provided to the service recipient is lower than the basis of interest calculation. Nonetheless, the general presumption should be that the economic value is decisive for determining the basic interest component, since it is obvious that in a third party relationship the expected economic lifetime plays an important role for the determination of any amortisation payments. However, the taxpayer should have the possibility of providing the evidence that the amortisation rate is different. If the taxpayer can do so, the lower value is to be taken into account. Based on the aforementioned conclusions, the calculation basis can be determined as the average economic value, i.e. typically stipulated as the average of the value at the beginning of the financial year and the end of the financial year.

Example: intangible property; depreciation period four years (straight line depreciation); expected economic lifetime five years; acquisition of the property at the beginning of the financial year 01 for an acquisition price of 1,000 Euro.

Figure 7:

beginning of the year 01:	end of the year 01/ beginning of the year 02:	end of the year 02:
book value: 1,000	book value: 750	book value: 500
adjusted value based on expected economic lifetime: 1,000	adjusted value based on expected economic lifetime: 800	adjusted value based on expected economic lifetime: 600

tax base: 900 (year 01) 700 (year 02)

The calculation basis for the year 01 is an amount of 900 Euro and for the year 02 an amount of 700 Euro. Extraordinary write-downs on the property, e.g. on the basis of an impairment test, should not have any impact on the calculation basis as long as the contract is still in place and to the extent that the contractual payments do not amortise the capital investment.

9.4.2.1.3. Leasing and Renting Activities Related to Movable Property

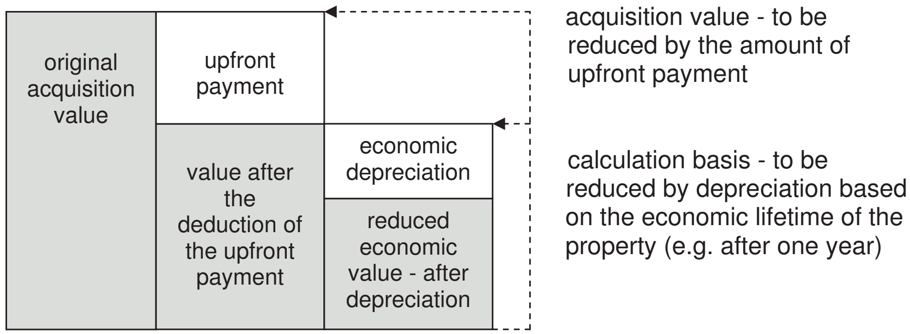
Essentially, the leasing and renting services provided by the CSC do not have to be treated differently from the licensing services, i.e. the determination of the calculation basis follows the same pattern. However, what can be different is the fact that leasing and renting services may require upfront payments or additional payments at the end of the contractual period. The latter can be deferred leasing payments as well as the purchase price for the transfer of the property to the recipient of the services. This, of course, leads either to an immediate reduction of the capital provided[52] or to an increase in the average amount of capital provided.[53] The question arises how to deal with these situations within the proposed system of CSC taxation and the determination of the calculation basis.

[52] In case of an upfront payment.
[53] In case of an additional payment at the end of the contractual period.

a.) Upfront payments

In the same way as described above, the economic value should be the underlying value for the determination of the calculation basis. However, it is clear that upfront payments made by the recipient of the services reduce the capital investment made by the service company (and therefore also the capital provided to the service recipient). For this reason, the upfront payments have to be deducted from the amount of investment (e.g. acquisition value) in order to avoid an excessive calculation basis. Such a treatment does not necessarily require the upfront payment to be considered, under accounting rules of the state of the service company, a reduction of the acquisition value of the property concerned. The approach is equally relevant for payments which are treated, from an accounting perspective, as deferred leasing income. In any event, the amount of investment - reduced by the upfront payment - is to be depreciated over the economic lifetime of the property according to the principles described above.

Figure 8:

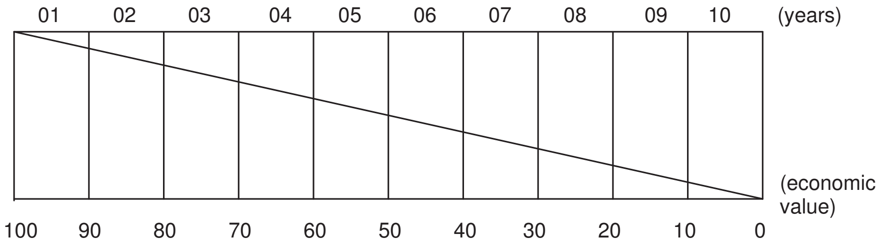


b.) Deferred payments

The deferral of payments to the end of the contractual period has the effect that the average amount of capital provided during that period is increased. The most extreme case is certainly the situation in which the regular service payments do not encompass any amortisation element, e.g. if the total value of the property is compensated at the end of the contractual period through a one-time payment. It is absolutely clear that the calculation basis cannot simply be derived from the economic value in such a situation. In this extreme case, the capital provided remains unchanged during the contractual period and the calculation basis is, in theory, the result of the respective economic value - reduced by depreciation - plus the difference to the original (acquisition) value. In other words, the calculation basis remains the same during the whole contractual period. However, what is more likely, in practice, is the situation in which only part of the acquisition value is compensated regularly during the contractual period and a final (reduced) compensation is due at the end of the period. That means the regular service payments contain an amortisation element which is lower than the depreciation based on the economic lifetime, but the difference will be settled by a one-time payment as soon as the contract terminates. In the latter case, the calculation basis is in-between the economic value (reduced by depreciation) and the original acquisition value. In the same way as described above, it is necessary to follow a rather simple and practical concept in order to avoid complicated mathematical determinations on a case-by-case basis. For this reason, it makes sense to stick to the economic value and to add a portion of the deferred payment to the tax base in order to take into account the increased amount of capital provided during the contractual period. In this regard, it is important to recognise the difference between the situation where the amortisation element included in the service payments remains unchanged during the contractual period - which can be the case if the service payments are adjusted during the contractual period in order to reflect the lower interest component - and the situation where the amortisation element increases over time while the interest element decreases (in case of unadjusted service payments). In favour of simplicity and practicability - and in favour of the taxpayer - the system may accept a straight line amortisation even if it is, from a mathematical perspective, not completely correct. Thus, it is acceptable, in my opinion, to add the portion of the deferred payment - calculated on a straight line basis - to the respective average economic value.

Example: the acquisition value of the property which is subject to a leasing arrangement is 100 Euro. The contractual leasing period and the expected economic lifetime are 10 years. The (final) payment which has to be made by the recipient of the services at the end of the contractual period is 100 Euro. The regular monthly payments of the service recipient encompass all of the other elements of the leasing arrangement (e.g. entrepreneurial risks, interest).

Figure 9:

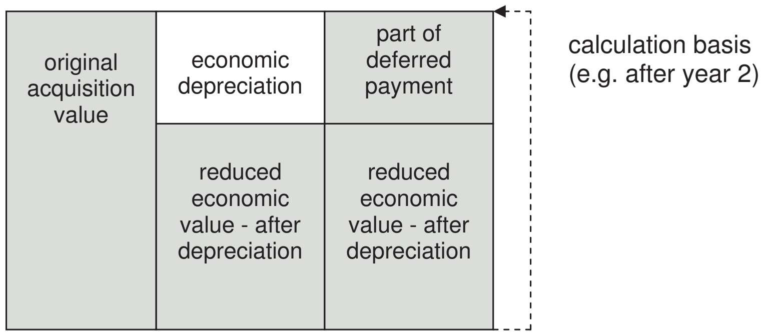


In this example, the economic value after one year is 90 Euro and the calculation basis for year 01 would be 95 Euro - under the assumption of a regular amortisation and a deferred payment of zero. However, the fact that a (final) payment of 100 Euro has to be made at the end of the 10 year period requires - as outlined above - that an amount of 5 Euro has to be added to the average economic value of 95 Euro. In the subsequent year 02, an amount of 15 Euro (5 Euro + 10 Euro)[54] has to be added to the average economic value of 85 Euro. In the following years, the amount which has to be added to the average economic value increases by 10 Euro each year (up to 95 Euro in year 10). Hence, the total amount added to the average economic value over the period of 10 years is 500 Euro[55] - which results in an average of 50 Euro per

[54] The amount of 15 Euro is half of the difference of the year 01 (10 x ½) plus the difference between the average amount of the year 01 (95 Euro) and the average amount of the year 02 (85 Euro).
[55] 5+15+25+35+45+55+65+75+85+95=500.

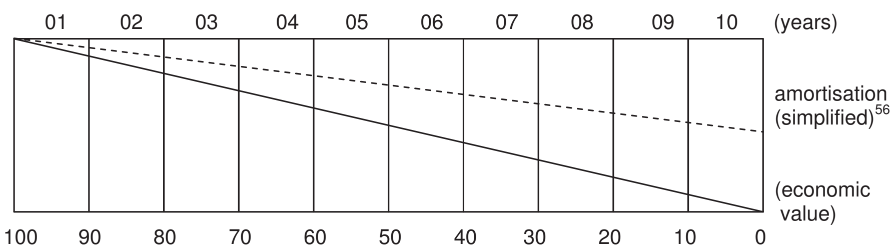
year. In this example, the calculation basis is - for the whole contractual period and in the absence of any amortisation payment made by the service recipient - equal to the original acquisition value.

Figure 10:



Example: the acquisition value of the property which is subject to a leasing arrangement is 100 Euro. The contractual leasing period and the expected economic lifetime are 10 years. The (final) payment which has to be made by the recipient of the services at the end of the contractual period is 50 Euro. The regular monthly payments of the service recipient encompass all the of the other elements of the leasing arrangement (e.g. entrepreneurial risks, interest, partial amortisation).

Figure 11:

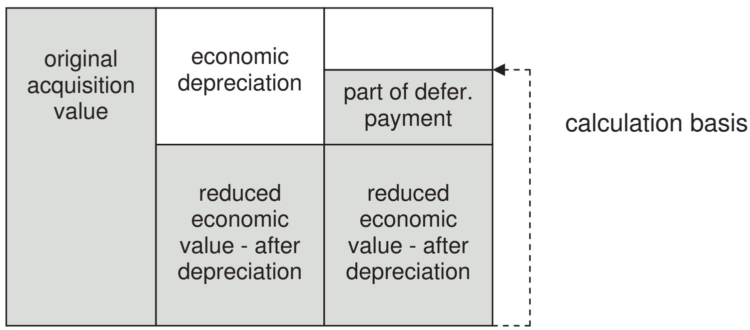


In contrast to the example above, the service payments include a reduced amortisation element. For this reason, only 2.50 Euro have to be added to the average economic value of 95 Euro in the year 01 (instead of 5 Euro). In the subsequent years, the average economic value has to be increased by 5 Euro per year (instead of 10 Euro). The underlying - simplified - assumption is that the lack of amortisation (which is in this alternative 50% of the regular amortisation) is to be allocated on a straight line basis. The total amount added to the average economic

[56] The amortisation is only linear if the amortisation element included in the service fees remains unchanged.

value over the period of 10 years is 250 Euro[57] - and therefore an average of 25 Euro per year. Again, it must be repeated once more that the assumption of a straight line (or linear) amortisation is not always mathematically correct, but it is a simpler and more practical approach which does not lead, in my opinion, to an inappropriate result.

Figure 12:



c.) Other cases

In general, it is possible that the contractual arrangements contain a mixture of pre-payments and deferred payments. In those cases, the principles outlined above have to be applied in order to determine the appropriate calculation basis for the taxation of the basic interest component, i.e. the upfront payment has to be deducted - in advance - from the acquisition value of the property and the deferred payment is to be added to the (reduced) average economic value. There are, in principle, no additional difficulties involved in those “mixed” cases and the respective approaches can be applied in combination. For any other “atypical” cases it should be clear that the calculation starts with the economic value. Based on the latter value, adjustments have to be made in order to reflect the differences to the “typical” cases and to end up with an appropriate calculation basis.

9.4.2.1.4. Leasing and Renting Activities Related to Immovable Property

In this context, the leasing and renting activities related to immovable property are mainly related to land and real estate, because intangible property is already covered by the licensing activities described above. In principle, there are no additional aspects which require an approach which is different from the system outlined above. Therefore, the calculation basis of land and real estate is to be determined on the basis of the economic lifetime of the property. With respect to land, it is likely that there is no “planned” decrease in the economic value, i.e. no regular depreciation can be applied. In this case, the calculation basis remains unadjusted during the contractual period. For real estate, there is no difference to the principles stipulated above for movable property.

57 2.50+7.50+12.50+17.50+22.50+27.50+32.50+37.50+42.50+47.50=250.

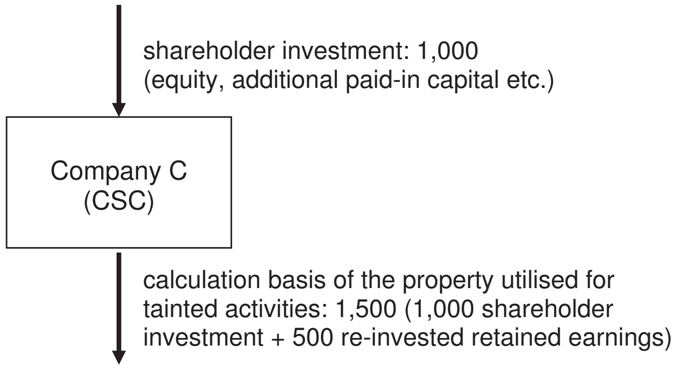
9.4.2.1.5. Other Activities

It should be clear that the aforementioned principles should be applicable in the same way to property which is not formally provided by way of loan agreements, licensing agreements, leasing agreements et cetera, but by way of transactions which are - in substance - comparable to such activities. It may also be the case that the provision of capital is not immediately visible from the balance sheet of the CSC. For example, leasing agreements may be seen by the state of the CSC - due to the atypical terms of the underlying agreement - as a sale of the property instead of a service agreement. In this case, the property may not be included in the balance sheet anymore, but - instead - receivables which have the character of loan amounts. Of course, the principles described above remain valid and can be applied equally to those situations, but it might be more difficult, in practice, to draw the right conclusions and to determine the calculation basis.

9.4.2.2. Possible Limitations and the Determination of the Net Calculation Basis

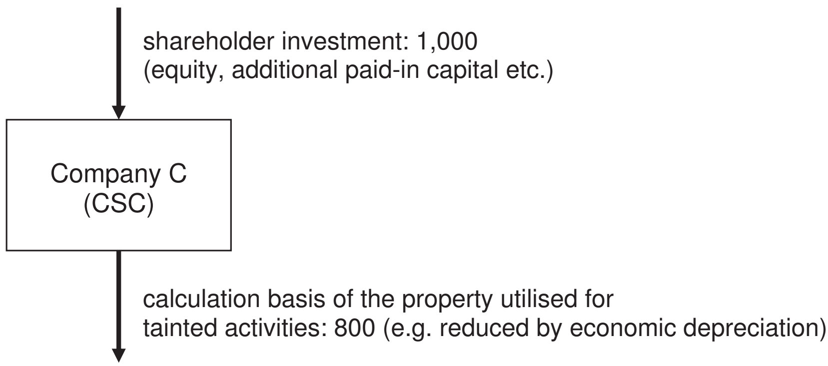
The calculation basis of the property concerned is one thing, but the actual investment of the shareholder in the respective legal entity another. The simplest case is certainly the situation in which the calculation basis of the property is exactly as high as the amount of capital invested by the shareholder. However, this is rather a theoretical scenario, at least if a period of more than one year is taken into account. In the latter case, it is much more likely that the calculation basis deviates from the amount of investment of the shareholder, i.e. the calculation basis is higher or lower. It may be higher if, for example, the earnings from the activity are re-invested and not distributed to the shareholder.

Figure 13:



The question arises whether the basic interest component should be calculated on the amount of 1,500 Euro or whether it should be limited to 1,000 Euro, which is the original investment of the shareholder (and which is therefore not identical to the total amount of equity of company C). The question is, in my opinion, not very difficult to answer since the *origin* of the capital invested in the property concerned is not relevant for the question whether it may be considered the basis for the basic interest calculation or not. In other words, the fact that the 1,000 Euro shareholder investment and the 500 Euro retained earnings originate from previously generated income which was either within or outside of the scope of the basic interest taxation is of no relevance whatsoever for the decision which has to be made regarding the newly generated income from the tainted activities and the calculation basis. Moreover, the decision for retaining the earnings on the corporate level for further investments instead of distributing the proceeds to the shareholder can be seen, in my opinion, as another investment decision of the shareholder which does usually not affect the book value of the investment of the shareholder. The latter, however, is of no importance for the overall assessment. It is therefore justifiable - and from my perspective even required - to focus, in the example, on a calculation basis of 1,500 Euro instead of the original 1,000 Euro. In addition, it has to be noted that any limitation would considerably “soften” the anti-avoidance element. This is particularly true in those cases where a significant service element and / or a significant risk element is included and where the profits are relatively high. Here, the basic interest component (computed on the lower calculation basis) would play an insignificant role after a few years. For example, if an original investment increases from 1,000 Euro to 3,000 Euro - through the re-investment of profits - and the basic interest component is only calculated on the original investment of 1,000 Euro, the effect of income allocation would be very limited. If the basic interest component is 4 percent, for example, it would only be 1.33 percent in relation to the actual amount of investment of 3,000 Euro (1/3 of 4 percent) which is now the basis for generating the positive income. Thus, it is also from an anti-avoidance perspective obvious that there should not be any limitation whatsoever to the original amount of investment by ignoring the subsequent re-investment of income on the level of the legal entity which carries out the tainted activities. However, it may be possible that the overall calculation basis is reduced and is below the original shareholder investment. This can be the case, *inter alia*, if the activity leads to negative income or if the positive income is distributed to the shareholder but the property is subject to depreciation and therefore the calculation basis is reduced on a yearly basis. The latter may also be true in a situation where the positive income is not distributed but invested by the legal entity in “non-tainted” property.

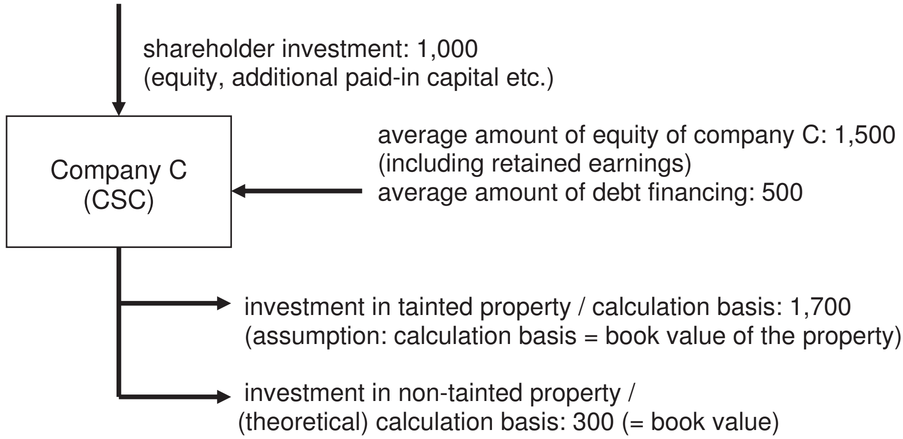
Figure 14:



Following the pattern outlined above, it would not make much sense to stick to the original investment of 1,000 Euro instead of the actual calculation basis of the property of 800 Euro. In the situation in which company C is compensated for the economic depreciation (e.g. in a leasing or licensing agreement), and taking into account the particular aspects which may be of relevance for the determination of the tax base, it is required, in my opinion, to ignore the higher shareholder investment and to concentrate solely on the lower calculation basis of the property in question. One must be aware that the (total) interest component included in the calculation of the service arrangement takes into account the amortisation payments during the contractual period, i.e. the interest component decreases. Hence, it would neither be economically required to stick to the original amount of investment nor would it be required from an anti-avoidance perspective. Again, this case must be separated from a situation in which the property is, for example, (temporarily) reduced by depreciation which is based on an impairment test. In those cases, the *calculation basis* itself will not be reduced as long as the contractual relationship is still in place and the payments are actually made.

Apart from these rather clear situations, one has to be aware that “real life” is much more complex. For example, it is not unlikely that part of the property is re-financed by loan amounts, and that the legal entity carries on “mixed” activities, i.e. part of the property is used for tainted activities and part of the property is used for non-tainted activities (and both activities might be partly re-financed). It is absolutely clear that any alternative anti-avoidance legislation has to provide for an economically and legally acceptable solution in these situations, too, but should nonetheless follow an approach which is as simple as possible under the given circumstances.

Figure 15:



In this example, the investment in tainted property (1,700 Euro) and non-tainted property (300 Euro) is refinanced by equity (1,500 Euro) and debts (500 Euro). Whether it is possible to allocate the amount of equity and debts directly to the respective property depends on the facts and circumstances. However, if the company carries on its activities in a low-tax state, it is not unlikely - from a tax planning perspective - that the non-tainted property is financed by equity investments and that the tainted income is, as much as possible, based on debt financing. This might lead to a reduction of tainted income under some of the existing CFC rules and increases the amount of positive income which is outside of the scope of such legislation. The same effect would exist under the proposed alternative anti-avoidance legislation if the rules follow strictly the debt-equity allocation of the taxpayer. However, since it is quite obvious that the debt-equity allocation can be easily influenced to the detriment of the state of the shareholder, the mechanism should follow a rather strict and simple pattern of debt-equity allocation. In this respect, it is important to note (and to repeat) that the allocation of the basic interest component is less restrictive than other regimes which follow the typical CFC pattern and which are based on the attribution of income generated by the service company without any vertical separation of this income. The effect of an allocation of equity to the tainted property (instead of the non-tainted property) for the purpose of determining the tax base merely has the effect that the basic interest component increases. This may lead - in a worst case scenario for the shareholder - to the calculation of the basic interest component on property which is used for a non-tainted activity. Clearly, this is not intended by the alternative regime, but it solely leads to a limited interest taxation on the property without taxing the total amount of income derived through the legal entity (which might otherwise be the case under a CFC regime). Hence, from an anti-avoidance perspective it seems to be justifiable to provide for a debt-equity allocation to the property of the legal entity which is based on the ratio between the average amount of equity and the average amount of interest bearing liabilities within the respective year. The determination of the average amount of equity should not be very difficult if there are no substantial and complex equity measures within the financial year. It may therefore simply be derived from the financial statements of the legal entity. The same should be true for the interest bearing liabilities if the legal entity re-finances part of its financing, leasing or licensing services with long-term debts which are not subject to changes or which are just reduced by regular amortisation within the financial year. However, the determination of the average amount of outstanding debts may require additional information if the liabilities are subject to permanent changes, e.g. in case of a cash pooling activity with other group companies. In this case, the determination of the average amount should follow exactly the same principles as outlined above with respect to the determination of the calculation basis for the loan receivables in a cash pooling structure. In the example, the average amount of equity is 1,500 Euro and the average amount of debts is 500 Euro. This would lead to the following general conclusion regarding the financing of the activities of the legal entity with equity and interest bearing liabilities:

1,500 Euro / 2,000 Euro (= 75 percent) is financed by equity, and

500 Euro / 2,000 Euro (= 25 percent) is financed by interest bearing liabilities.

The non-interest bearing (current) liabilities are left aside for the calculation. The latter are typically of no relevance for the long-term re-financing and, therefore, should not be taken into account for the determination of the calculation basis. In other words, what matters is the ratio between the equity of the company and the interest bearing liabilities. Thus, based on such an approach, the equity element within the total (average) amount of interest bearing liabilities plus equity is 75 percent. The latter percentage can now be applied to the calculation basis of the tainted property in order to determine the net calculation basis. The calculation basis of the *non*-tainted property (300 Euro) is of no relevance in this respect and need not be calculated.

1,700 Euro calculation basis x 0.75 = 1,275 Euro net calculation basis.

In the example, the basic interest rate is to be applied to the net calculation basis of 1,275 Euro and not on the amount of 1,700 Euro. It is important to note, however, that any adjustment of the calculation basis compared to the actual book value, e.g. because of an extraordinary high depreciation rate, should have an effect on the amount of equity applied for the determination of the ratio, too. For example, if it is assumed that the *book value* of the tainted property is 1,700 Euro and the *calculation basis* is 2,100 Euro - because of an increased depreciation which had to be corrected - the adjustment of 400 Euro should also increase the average amount of equity which is applied for the determination of the ratio. In principle, it may be concluded that such an equity adjustment is required in those cases where the difference had any effect on the equity of the legal entity, i.e. in particular in those cases where the difference is due to a profit and loss effective measure (as is the case for the increased depreciation). In those cases where the calculation basis substantially deviates from the book value just because of the fact that the average value of the property within the year is considerably higher than the book value at the end of the year, there is no necessity for a corresponding adjustment of the equity or debt basis. The reason is that in such a situation the simultaneous calculation of the average amount of equity and interest bearing liabilities reflects this deviation, too. For example, if the calculation basis of the cash-pooling receivables of the legal entity is 5,000 Euro, but the book value at the end of the year is only 1,000 Euro, the average amount of loan payables will most certainly also be higher than the book value at the end of the year. It is absolutely clear that such a simplified allocation rule does not necessarily fit in any situation and under all circumstances. However, it provides a method which, in my opinion, is simpler than most of the existing CFC rules and which leads to an appropriate allocation of interest bearing liabilities in order to determine the net calculation basis for the application of the basic interest rate.

9.4.3. Permanent Establishments and Transparent Entities

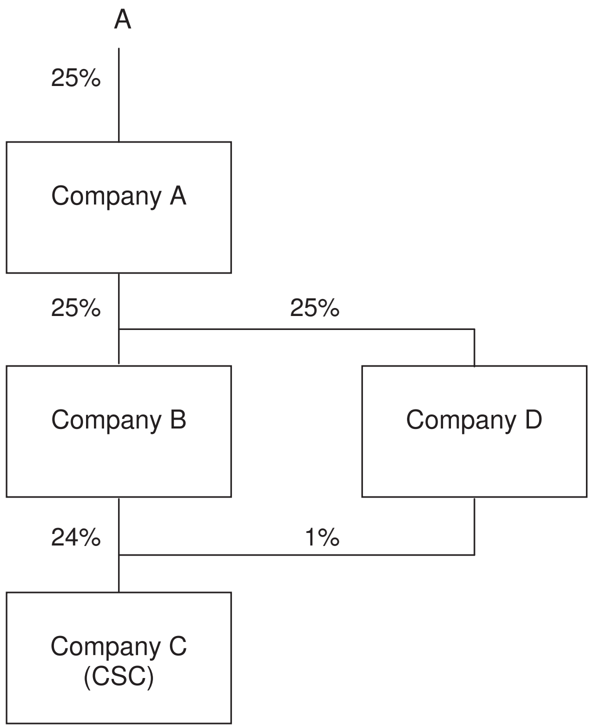
The conclusion that the tainted property which is allocable to the PE of a legal entity or to a transparent PS has to be taken into account for the CSC taxation raises the question whether the property of the PE (PS) should be treated separately from the property of the legal entity or whether it has to be consolidated for all of the required calculations. From my perspective, it is simpler, at least with respect to PE (PS) activities which are carried on in a state which is different from the state of the headquarter company, to separate the property of the PE (PS) from the property of the headquarter company. Essentially, the position would be similar to an alternative situation where the PE (PS) is replaced by a non-transparent legal entity. This does not only provide for an equal treatment of PE (PS) and non-transparent legal entities, but also seems to be a more practical approach compared to any solution which is based on consolidation. One should not forget that a separation of the calculation basis is required anyway since the amount of taxes imposed on the basic interest income is most likely not identical in the two states involved. Thus, it makes some sense, in my opinion, to consider the allocation of the property - which has to be made anyway in order to fulfil the requirements of the tax jurisdictions involved - and to start on such a basis. In other words, the allocation of the tainted property of the PE (PS) and the legal entity to the jurisdictions involved follows the property allocation which has to be made for income tax purposes. The same should be true for the question of how much of the interest bearing liabilities are allocable to the PE and the headquarter company. Such an approach ensures that the basis for deriving the actual taxable income and the net calculation basis for the basic interest component are consistently allocated to the respective states (PE / PS state and headquarter state). The separation is not only required if tainted property is held by the headquarter company and the PE (PS), but is equally required if only one of the two parties carries on a tainted activity (and the other party carries on a non-tainted activity).

9.4.4. The Percentage of Shareholding or Voting Rights in the CSC

Pursuant to the principles outlined earlier, the current taxation of the basic interest component under the CSC system should only be applied if the 25 percent threshold (shareholding or voting rights) in the respective entity is reached or exceeded. That means, the CSC legislation should be applicable if one of the two percentages - either the percentage of shareholding or the percentage of voting rights - is at least 25 percent. The differentiation between the percentage of shareholding and the percentage of voting rights ensures that any substantial shareholding falls within the scope of the alternative legislation. Although the lower percentage of voting rights may reduce the influence of the shareholder, the 25 percent shareholding still represents a significant portion of investment in the company. As already described earlier, I do not see the necessity for an absolute financial threshold in addition to the percentage of shareholding or voting rights. There is, in my opinion, a substantial difference between a shareholding which represents one quarter of the total investments on the one hand, and a shareholding - although substantial from the perspective of the absolute amount - which represents just a small fraction of the total investments on the other hand.

However, the question arises whether the minimum percentage should be relevant only for the investment in the entity which carries on the tainted activities or whether it should be a minimum requirement for the shareholding in all of the intermediate companies. The approach followed by the existing CFC regimes is not uniform in this respect.[58] Thus, one possibility is to follow a system according to which the shareholder must have a direct or indirect participation of at least 25 percent (shareholding or voting rights) in the entity which carries on the tainted activities and - in case of multiple-tier structures - in all of the intermediate holdings. This ensures an uninterrupted chain of shareholdings with a participation of at least 25 percent, and therefore a consistent influence on the tainted activities independent from the number of tiers interposed between the shareholder and the entity in question.

Figure 16:

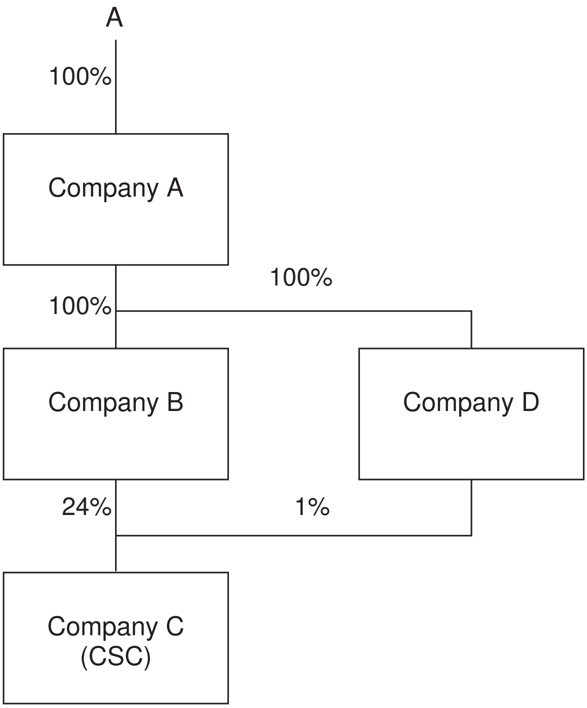


[58] See chapter 6 in this respect.

In this example, the basic interest component would be allocable to company A and the individual shareholder A, since both shareholders hold an *uninterrupted* participation of at least 25 percent in the intermediate companies *and* in the company on the lowest tier which carries on the tainted activities. Shareholder A holds 25 percent in company A which, in turn, holds 25 percent in company B and in company D. The latter two companies hold together at least 25 percent in company C (24 percent plus 1 percent). Essentially, the individual shareholder A has always - alone or combined - the influence of a one-quarter shareholding. However, there are two aspects which should not be overlooked: first, the actual percentage of (indirect) shareholding of the individual shareholder A in company C is only 1.5625 percent[59] and the actual percentage of (indirect) shareholding of company A in company C is only 6.25 percent.[60] The percentage of income allocable to the shareholders in state A is therefore extremely low. In this case, it may be theoretically required to stipulate a minimum participation in order to ensure that the administrative burden is proportionate to the aim pursued. Second, the individual shareholder A not only has the burden of gathering the necessary information with his 25 percent (indirect) participation in company C but must also enforce his interest - to fulfil his obligations - in all of the intermediate companies. Overall, it seems to me that both factors combined - the “watering down” of the percentage of participation and the administrative obstacle - do not really support such an approach. In my opinion, the focus should solely be on the percentage of participation in the company which carries on the tainted activities. In other words, the respective shareholder must have a direct or indirect participation of 25 percent in the CSC. The shareholding in the intermediate company is, in principle, not decisive. Mathematically, however, it is obvious that the shareholding in the intermediate companies must be higher than 25 percent.

[59] Which is the result of ¼ x ¼ x 25 percent in company C.
[60] Which is the result of ¼ x 25 percent in company C.

Figure 17:



In the multiple-tier structure above, the shareholding on a higher group level must be 100 percent in order to end up with an indirect participation of 25 percent in company C. This ensures the access to the information which is required for the calculation of the basic interest component similar to a direct shareholding of the individual and corporate shareholders of state A in company C. Of course, if the percentage of combined shareholding of company B and company D is higher than 25 percent, the percentages on a higher level may be below 100 percent. For example, if it is assumed that company B holds 50 percent instead of 24 percent and the shareholding of company D remains unchanged, the shareholding of company A in company B may be reduced to 48 percent (instead of 100 percent) without being outside of the scope of the current income attribution. If the direct shareholding of company B in company C is 99 percent, the shareholding of company A in company B may even be reduced to 25 percent in order to fulfil the shareholding requirement.[61] Such an approach sets a threshold which is higher than in case of a requirement which focuses on the 25 percent minimum threshold on each of the intermediate levels. It is obvious, however, that it may very well lead to the result that the legislation may be applied to company A but not necessarily to the individual shareholder A if the latter holds a percentage which is below 100 percent - and therefore does not reach an indirect shareholding of 25 percent in company C.

[61] This requires, again, that the shareholding structure which involves company D remains unchanged.

Essentially, it strictly ensures that only a minimum calculative percentage of 25 percent triggers the income allocation and, at the same time, ensures that the income allocation as such - under normal circumstances - is not lower than 25 percent of the basic interest component calculated on the tainted property of company C. In my opinion, the latter mechanism of calculating the minimum threshold for the application of the anti-avoidance legislation can be considered an appropriate approach which supports the balance between administrative obligations and the safeguarding of the current taxation of income.

9.4.5. The Allocation of Income to the Shareholder

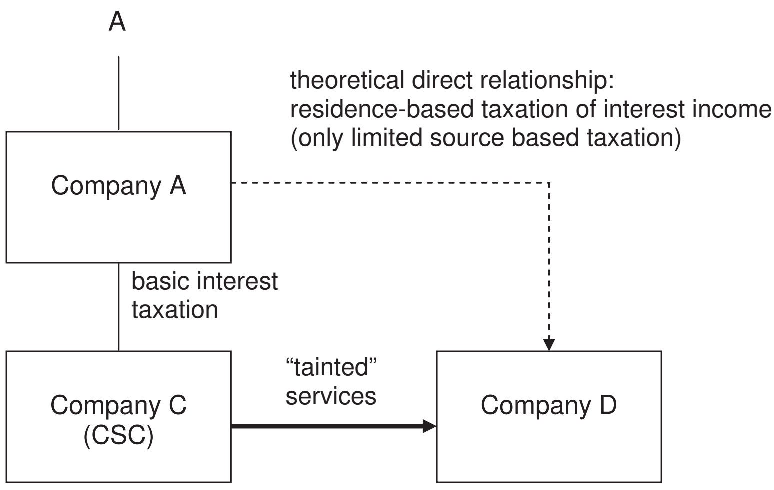
If the aforementioned requirements are fulfilled, the basic interest rate is to be calculated on the net calculation basis and is to be attributed to the domestic shareholder. From a practical perspective it may be advisable - or even required - to attribute the basic interest income to the shareholder only after the end of the financial year of the company which carries on the tainted activities. Thus, if the financial year of the latter company and the financial year of the shareholder are identical, the income calculated on the tainted property should be included in the tax base of the domestic shareholder in the subsequent tax period and not in the same tax period. This provides sufficient time for the domestic shareholder to gather the necessary information for the respective tax assessment. For example, if company C has a financial year which is equal to the calendar year, the basic interest income of the year 01 should be included in the tax base of the domestic shareholder in year 02 (assumption: tax year of the domestic shareholder is equal to the calendar year, too). For financial years which deviate from the calendar year, the basic interest income should also be attributed to the shareholder immediately after the end of the financial year, and should therefore be included in the tax year which is open at that point in time. For example, if the financial year 02/03 of company C ends at the end of April 03, the basic interest income should be included in the tax year 03 - if it is still open and not closed on or before April 03. In the latter case, the basic interest income should be included in the subsequent period 03/04. In any case, if two (or more) domestic taxpayers are involved in a multiple-tier structure, and the amount of income is not only attributed to the corporate shareholder but also, for example, to an individual shareholder who holds the shares in the domestic company, the proposed legislation should ensure that one and the same basic interest component is included in one and the same tax period for all of the domestic taxpayers which are in “the same line of shareholding.” The latter may be of particular importance for a consistent relief from double taxation under the proposed tax credit system.

Also in this case one should (again) keep in mind that the proposed legislation of a current taxation of income should not lead to any penalisation of activities but should merely ensure the proper taxation of the basic interest component.

9.4.6. Limitation of the Income Tax Rate?

It was outlined in previous chapters that the income should be taxed in the state in which it is actually produced and that a source-based taxation would therefore be the optimal result from an economic and equity perspective. Any taxation in the state of the intermediate service company or the state of residence of the shareholder should, theoretically, be restricted to the tax rate which would be applied in the state where the income is produced. It seems to me, however, that this might be very difficult to achieve, especially in those cases in which not only one recipient of the capital services is involved but a large number of recipients in different states. It would require the separation of the tainted property of a company and the creation of a link between the tainted property and the state where it is actually utilised for an income-producing activity. In my opinion, this would result in an extremely complex system which would be very difficult to handle from an administrative point of view. Therefore, the question must be raised whether it is acceptable to apply the regular tax rate applicable in the residence state of the shareholder to the total amount of attributed income without any limitation to the tax rate which would theoretically be applicable in the state where the income is actually produced. From my perspective, the answer can be in the affirmative in those cases in which - in the direct relationship between the state where the tainted property is utilised and the state of the shareholder which applies the anti-avoidance legislation - the right to tax the interest component is allocated to the state of residence and not to the state of source (leaving aside the limited taxation by way of withholding tax). In fact, this is the approach under the OECD-MTC. Here, it is clearly acceptable, in my opinion, that the residence state applies - in the context of the proposed anti-avoidance legislation - the regular domestic rate and does not provide a limitation to the tax rate of the source state. However, the situation is different if the residence state has concluded a tax treaty which provides for a strict source-based taxation. In those cases, the non-restriction to the income tax rate in the state of income production may only be justified by administrative reasons and the importance of the anti-deferral legislation for the state of residence.

Figure 18:



In this example, it would be acceptable, in my opinion, that state A taxes the basic interest component without any limitation to the corporate income tax rate which would theoretically be applicable in state D. In other words, the basic interest income (but not more!) would be taxed, in essence, like any other income derived directly by company A and in the same way as if the latter company had granted the services (e.g. financing services) directly to the recipient in state D. The procedure of income allocation as well as the tax credit system will be outlined in the following.

9.4.7. The Tax Credit System

Any system which focuses on the current allocation of income should not have negative effects for the domestic shareholder - apart from the fact that the allocable income might be taxed at a higher rate (e.g. if the allocable income is derived by an entity in a low-tax state). The latter effect of a higher income tax burden on the basic interest component is an effect which is immanent in the system and required by economic and equity principles.[62] Apart from this effect, however, there is no reason to treat this allocated income different from any other income or to allow a systematic double taxation just because of the fact that the income is currently attributed to the shareholder. One should always keep in mind that such a system should not have any kind of penalty effect for the investor. There is neither any requirement nor any justification for a disadvantageous treatment. It is therefore very important that the state which applies such legislation provides for an appropriate (modified) system of relief from double taxation of income in order to avoid any distortions. It was outlined earlier that this is not necessarily provided for in case of existing CFC regimes, e.g. if the domestic shareholder derives negative income or has a tax loss carry forward available, if the CFC itself generates negative income, and - in particular - if multiple-tier structures are involved.[63] However, it would be too simple, in my opinion, to accept a double taxation of income caused by the non-crediting of income taxes in cases where, for example, tax losses (or tax loss carry forwards) are involved - no matter on which group level. This is of particular importance in a system in which the income attribution is not limited to the direct shareholder but also includes the indirect domestic shareholder, e.g. the individual shareholder. Thus, an alternative anti-avoidance legislation requires a current attribution of the basic interest component *combined* with a strict and consistent system of elimination of the double taxation of income.

a.) The general mechanism of the tax credit system

The general mechanism should be based on an ordinary tax credit system - as proposed in chapter 6 - where the income taxes imposed on a lower level are consistently taken into account. A system which provides for a full tax credit, i.e. the reimbursement of an exceeding tax burden, is neither systematically required nor is it very realistic to be implemented in a cross-border situation as long as each Member State focuses on its own budget without any intra-EU compensation among Member States. In principle, the mechanism leads to a (total) tax burden which is equal to the highest tax rate applied within the group structure. This can be the income tax rate of the ultimate individual shareholder or - in a multiple-tier structure - the corporate income tax rate of a company established in a high tax state and interposed between the ultimate shareholder and the CSC.

[62] At least to the extent that the income derived through the intermediate company is subject to a lower taxation than in the state of residence of the shareholder and the state where the income was produced.
[63] See chapter 6 for more details.

Figure 19:

	Alternative 1	Alternative 2
A	tax base 100 x 40% tax = 40 ./. 30 tax credit = 10 tax burden	tax base 100 x 25% tax = 25 ./. 25 (max.) tax credit = 0 tax burden
Company A	tax base 100 x 30% tax = 30 ./. 10 tax credit = 20 tax burden	tax base 100 x 30% tax = 30 ./. 10 tax credit = 20 tax burden
Company C (CSC)	basic interest component 100 x 10% tax = 10 tax burden	basic interest component 100 x 10% tax = 10 tax burden

The simplified example shows that the overall tax burden is influenced by the state which applies the highest tax rate and, within this state, by the differences in the taxation between the individual shareholder and the corporate shareholder. In the first alternative, it is the income tax of the individual shareholder A (40 percent) which is responsible for the overall and final tax burden imposed on the basic interest component. The tax burden on the intermediate level (30 percent) is “neutralised” completely. In the second alternative, the tax burden is influenced by the tax rate applicable on the intermediate level since the taxation is higher (30 percent) than on the level of the ultimate individual shareholder in state A (25 percent instead of 40 percent in the first alternative). This is the result of the consistent application of an ordinary tax credit system. In general, the result would be the same if additional companies are interposed between A and the CSC, as long as the tax burden is not higher than 40 percent (first alternative) and 30 percent (second alternative), respectively. However, this is only true as long as the intermediate companies and the ultimate individual shareholder are in a position to credit the income taxes imposed on the respective lower group level. Otherwise, the overall income tax burden might be increased considerably.

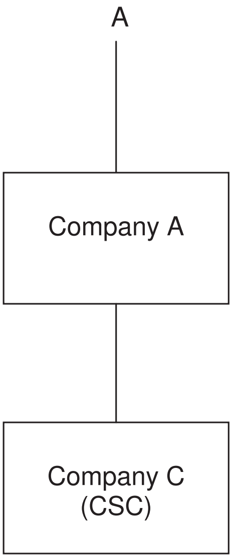
b.) The modified mechanism for the alternative anti-avoidance legislation

It should not be overlooked that an anti-avoidance legislation which focuses on the current attribution of income is different from the “normal” procedure which is applicable in case of profits derived by a separate legal entity. In principle, such legislation requires a two-step approach which deals first with the current attribution of income and, second, with the treatment of subsequent distributions (or the subsequent disposal of shares). The second step should finally lead to a treatment of the income component which is not different from any other income generated by a (domestic or foreign) legal entity and which is finally distributed to the ultimate shareholder. The second step will be discussed separately. Regarding the current taxation of income - in the first step - it is important to note that the approach outlined here goes further than the typical CFC legislation. The reason is that the income attribution in the proposed system is not only made to the direct shareholder but also to the indirect (ultimate) domestic shareholder.[64] The important question is, however, whether the income in the hands of the individual shareholder should be taxed according to his personal income tax rate, which can be based on a progressive system, or whether a (preliminary) flat rate should be applied. In my opinion, the taxation under a progressive system is not necessarily required in the first step of income allocation since the income will be determined and taxed separately (in a different schedule - see below) and will be subject to a “final” taxation as soon as the income is actually distributed to the individual shareholder. However, the system should lead to a strict current taxation of the basic interest component in the hands of the individual shareholder, no matter how many entities are interposed between the shareholder and the CSC in question. That means, the interposition of loss-making entities - or entities with a tax loss carry forward - should not have the effect of a complete sheltering of income attribution to the shareholder on a higher level, be it a corporate shareholder or an individual shareholder. In my opinion, it is therefore obvious that the individual shareholder, even if he only indirectly participates in the respective “tainted” activities, should be integrated in the system of current income allocation. On the other hand, the system might have a distorting effect if the individual shareholder is subject to a personnel income taxation which is based on a progressive system. The latter system can have the effect of a higher income taxation than in case of a system in which the taxation only occurs when the legal entity actually distributes the respective income. Therefore, it seems to be acceptable to determine - only in the first step of income allocation - a fixed percentage of income tax (flat income tax rate) which can, for reason of simplification, be derived from the corporate income tax rate of the state which applies the anti-avoidance legislation. Only the subsequent distribution shall then be subject to income taxation according to the regular system applied in the residence state of the shareholder. The difference between the income taxes paid in the first step and the income taxes paid in the second step should be taken into account (e.g. credited against the income taxes imposed in the second step).

[64] In case the participation threshold is reached or exceeded.

Figure 20:

Alternative 3



tax base 100
x 30% tax (limitation for attributed income) = 30
./. 30 tax credit = 0 tax burden

tax base 100 x 30% tax = 30
./. 10 tax credit = 20 tax burden

basic interest component
100 x 10% tax = 10 tax burden

The application of a (preliminary) flat tax on the level of the individual shareholder A has the effect that, in this example, no additional income tax burden exists in the first step of income allocation. Thus, the overall income tax burden in the structure amounts to 30 Euro (or 30 percent). If the intermediate company is established in another state, e.g. in state B instead of state A, the outcome depends on the corporate income tax rate in state B. If the rate is above 30 percent, there would be no additional income tax payment for the individual shareholder A, either (first step). If the rate is below 30 percent, the difference between the flat rate of 30 percent in state A and the effective income tax in state B would have to be paid by the individual shareholder. The same would be true if shareholder A holds the participation in company C directly, i.e. without the interposition of company A. In this case, the additional income tax payment of shareholder A would be 20 Euro instead of 0 Euro (first step).

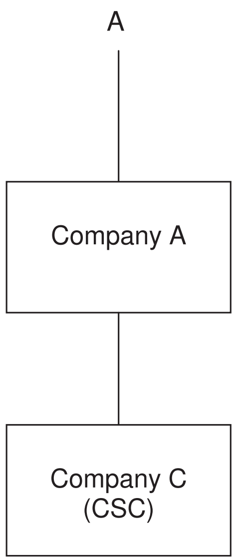
c.) The modified mechanism in case of tax losses of the shareholder(s) in the CSC

In my opinion, an alternative anti-avoidance system must provide for a consistent elimination of double taxation. This is not only true for those cases in which positive income is generated by the group entities, but all the more in those cases in which the crediting of income taxes is usually impossible, e.g. in case of negative income if no income tax burden of the group entity itself arises in the respective tax period.[65] If the system fails to provide for an appropriate relief, as is the case for most of the

[65] In cases in which a roll-over exists, there may be the possibility of carrying forward the creditable taxes.

existing CFC regimes, the current attribution of income may lead to a substantially higher income tax burden than (i) in a fictitious situation where the income is generated directly by the ultimate shareholder or (ii) in a situation where the income is not currently allocable to the shareholder but can be distributed (and taxed) according to the decision of the shareholder(s) in the respective entity. Again, it must be clear that the system should lead to an immediate taxation of the basic interest component in the hands of the (ultimate) shareholder, but not if the consequence is a systematic double taxation.

Figure 21:



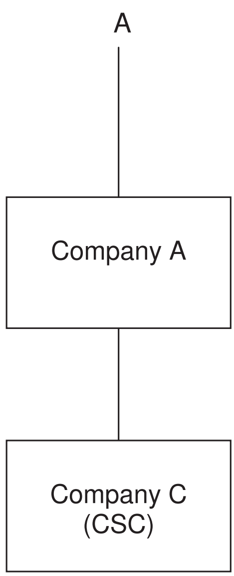
tax loss carry forward
tax base 100 x 30% tax = 30
./. 25 tax credit = 5 tax burden
payment can be *postponed* until the tax loss carry forward is utilised

tax base 100 x 25% tax = 25
./. 10 tax credit = 15 tax burden
(assumption: *effective* tax rate of 25% instead of 30% / alternatively: the company is established in another state with a tax rate of 25%)

basic interest component
100 x 10% tax = 10 tax burden

Instead of an offsetting of the attributable income with the tax losses of shareholder A it seems to be more consistent to make a separate calculation of the theoretical tax burden as if no tax losses were existent. This requires, however, a separate schedule (or "box") for the current taxation of the basic interest component. In this case, the tax losses (or the tax loss carry forward) of shareholder A remain unaffected by the income attribution. The payment of the final tax burden of 5 Euro - after the crediting of the corporate income tax of 25 Euro (in this example it shall be assumed that the effective tax rate is below 30 percent) - should be postponed, by application of the domestic taxpayer A, to a subsequent tax period in which the positive income - without taking into account the current income attribution - exceeds the tax losses (the tax loss carry forward). In other words, the taxes imposed on the current income attribution should only be paid as soon as the losses are completely offset and shareholder A is in a position to pay the amount of tax on the corresponding positive income. Practically, the payment could be due after the finalisation of the tax return for the respective year (when a positive income balance exists for the first time after the current income attribution). If it is assumed - in the example - that the income allocation of 100 Euro takes place in year 01 and the (separately determined) tax loss carry forward of shareholder A is 150 Euro, the payment of 5 Euro income tax can be postponed. If the positive income in the following year is 250 Euro (without any inclusion of a current income attribution), the tax loss carry forward of 150 Euro can be offset completely against the positive income of 250 Euro and a positive balance of 100 Euro remains which is subject to tax in state A. The positive balance now has the consequence of triggering the payment of 5 Euro tax related to the attribution in year 01 after the submission of the tax return for the subsequent year. In effect, the positive income of 100 Euro (250 Euro minus 150 Euro tax loss carry forward) triggers the “regular” domestic income taxation of, for example, 40 Euro (40 percent) plus the 5 Euro tax which was originally postponed. However, this does not mean that the amount is taxed with 45 percent, but it is just the “simultaneous” effect of taxing the positive income of 100 Euro according to the ability-to-pay principle, on the one hand, and triggering the payment of the additional 5 Euro which was determined in an earlier period on the basic interest component included in the investment in company C, on the other hand. In principle, the outcome would be the same if the intermediate company is established in state B instead of state A.

<u>Figure 22:</u>



tax base 100 x 30% tax = 30
./. 10 tax credit = <u>20</u> tax burden
income tax determination may be subject to adjustments - depending on the situation of company A (*preliminary tax determination*)

<u>tax loss carry forward</u>
tax base 100 x 30% tax = 30
./. 10 tax credit = <u>20</u> tax burden
payment can be *postponed* until the tax loss carry forward is utilised

basic interest component
100 x 10% tax = <u>10</u> tax burden

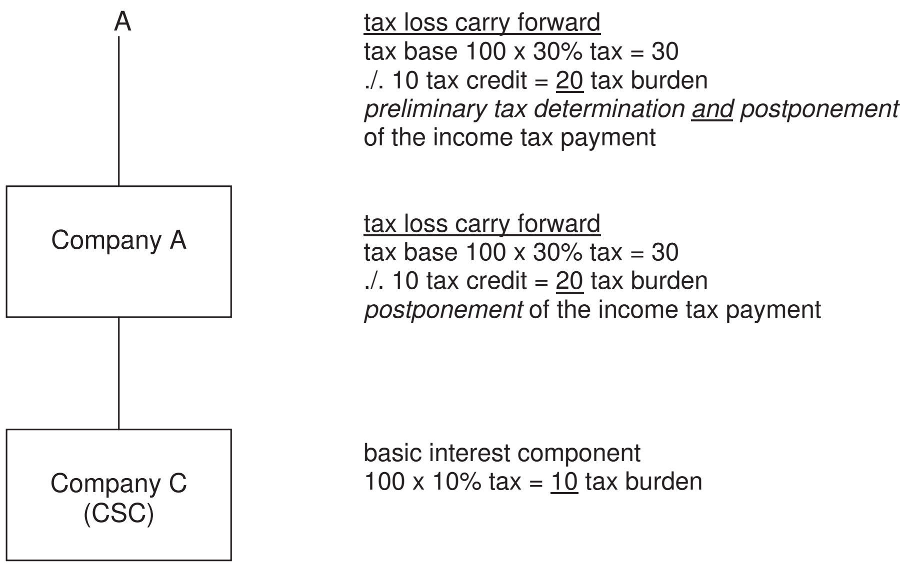
What was outlined above with respect to the tax treatment of the individual shareholder A in case of tax losses is equally true for the tax treatment of the subsidiary company A, i.e. the tax payment of 20 Euro can be postponed until the losses are actually utilised. If it turns out that the losses cannot be utilised, e.g. due to the fact that company A has to be liquidated before the losses can be offset, the corporate income tax of 20 Euro would not have to be paid by company A at all. The tax treatment of shareholder A, in turn, strongly depends on the situation of company A. The current attribution of income to shareholder A triggers an income taxation of 30 percent. The fact that company A does not have to pay any corporate income tax on the attributed income as long as the tax loss carry forward is not utilised must be taken into account. It should lead to a (preliminary) limitation of the tax credit for shareholder A to the corporate income tax paid in state C of 10 percent. Thus, there are, in principle, two possible scenarios in subsequent years:

- The tax loss carry forward of company A is utilised. In this case, the tax burden of company A is final and payable to the tax administration in state A (20 Euro). This has the consequence that the preliminary taxation of shareholder A is to be adjusted. Instead of a tax credit of 10 Euro a final tax credit of 30 Euro is to be taken into account. The effect is a repayment of 20 Euro income tax which was originally paid by shareholder A.

- The tax loss carry forward of company A cannot be utilised. In this case, the tax burden of company A will be adjusted. This has the consequence that the preliminary taxation of shareholder A becomes a final tax assessment.

The result of such a dependency is the consistent avoidance of double taxation of income, on the hand, and the safeguarding of a current taxation of the basic interest component in the hands of the shareholder, on the other hand.

Figure 23:

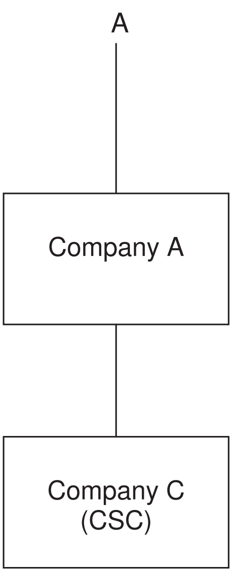


The situation in which two (or more) shareholders suffer tax losses simultaneously (or have tax loss carry forwards available) is not substantially different from the previous example. Here, both taxpayers (company A and individual A) may apply for a postponement of the payment of the income taxes. In both cases, the 10 percent tax paid in state C is to be taken into account, although this is solely determined on a preliminary basis for the individual shareholder A. If company A starts paying taxes before the losses of the individual shareholder A are utilised, the 20 Euro income tax have to be paid to the tax authorities in state A. This would have the consequence of an adjustment of the preliminary tax determination of shareholder A. The additional tax burden of A would be zero (instead of 20 Euro). However, if the tax burden was not zero, in an alternative scenario where the final tax credit is below 30 Euro, shareholder A might still apply for a postponement of the tax payment until his own tax loss carry forward is utilised.

d.) The modified mechanism in case of tax losses of the CSC

The concept of income allocation under the alternative system is based on the idea of the current taxation of the basic interest component of capital. The actual income derived by the activity is only secondary. Depending on the risks taken by the service provider (in the example company C), there may be years in which the positive income derived by the activity considerably exceeds the basic interest component allocated to the shareholder. However, the risks taken by the entity may also result in negative income. In principle, the losses should be excluded from the considerations in the same way as the (positive) risk component is excluded from any income allocation. This would be a consistent approach. However, one should not overlook the fact that the system is foremost an anti-avoidance system. Thus, the consistent and permanent allocation of the basic interest component is required, but not necessarily the payment of the income taxes imposed on that particular portion of income as long as the actual positive result of the service entity does not exceed the negative income derived from its activities. If the result of company C is permanently negative, there is no necessity to impose the additional income taxes on the basic interest component in the state of the shareholder during this time period.

Figure 24:



tax base 100 x 30% tax = 30
./. 0 tax credit = 30 tax burden
preliminary tax determination and postponement
of the income tax payment

tax base 100 x 30% tax = 30
./. 0 tax credit = 30 tax burden
preliminary tax determination and postponement
of the income tax payment

negative income / tax loss carry forward
no tax burden in state C

In the example, company A and shareholder A can apply for a postponement of the payment of income taxes based on the preliminary tax determination. However, the postponement is strictly dependent on the situation of company C. As soon as the income of company C is positive and the positive income exceeds the existing tax loss carry forward in state C, the preliminary tax determination has to be adjusted (since the taxes imposed in state C have to be taken into account) and the income tax in relation to the positive income would have to be paid to the tax authorities in state A. The question may be raised whether the 30 percent corporate income tax of company A should already be credited against the 30 percent income tax of individual A. Without such a crediting, both assessments are made on the same basis and without taking into account the corporate income taxes of company A. In my opinion, the crediting of the income taxes should be directly linked to the actual payment. In other words, if company A applies for a postponement of the payment of the corporate income taxes, the crediting of the taxes should be postponed, too. In contrast thereto, if company A actually pays the corporate income taxes determined preliminarily, the individual shareholder A should be allowed to credit the 30 percent corporate income taxes in the context of the preliminary tax assessment. In any case, the problem is not significant, since both shareholders can apply for the postponement of the income tax payment. The effect over a period of three years may be illustrated in the following (the impact for the individual shareholder A is left aside for reason of simplification - the consequences may be derived from the previous examples):

	Year 01	Year 02	Year 03
income of company C	(300)	200	500
basic interest component	100	100	100
preliminary tax company A (subject to postponement)	30	30	-
final calculation for company A 300 x 30% = 90 ./.30 tax (in 03)	-	-	60

However, this calculation should be equally relevant in a situation in which the losses occur after a period of positive income. In such a case, the taxation should nonetheless be subject to postponement until the negative income is offset by subsequent positive income (by application of the shareholder). In the following example it is assumed that no tax loss carry back is available in country C.

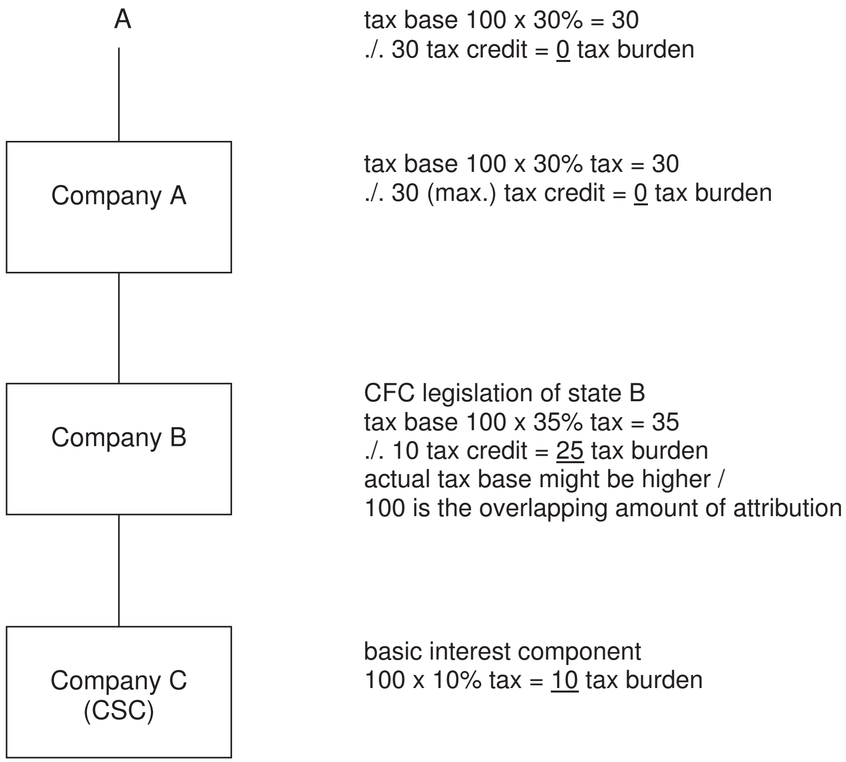
	Year 01	Year 02	Year 03	Year 04
income of company C	300	(100)	(500)	900
basic interest component	100	100	100	100
taxation of company A (without any postponement) 100 x 30% = 30 ./. 10 tax	20	-	-	-
preliminary tax company A (subject to postponement)	-	30	30	-
final calculation for company A 300 x 30% = 90 ./. 30 tax (in 04)	-	-	-	60

In this example, the basic interest income of the year 01 is subject to final taxation (without any postponement). Theoretically, the accumulated income at the end of the year 02 is still positive (300 Euro minus 100 Euro). Nevertheless, the alternative system should provide for a postponement of the taxation of the basic interest component (years 02 / 03) until the positive income in subsequent years is high enough to cover the losses of the previous years. Such an approach does not look at the situation and the positive income of company C in previous years and the question whether the income was accumulated in the company or distributed to the shareholder. This is a forward looking approach to keep the legislation as simple as possible and to "start counting" from the year in which the loss was realised. Hence, the basic interest income of the years 02 and 03 will be subject to final taxation in the year 04 together with the basic interest income of the year 04. Overall, the additional corporate income tax in state A (after tax credit) for the years 01-04 amounts to 80 Euro.

e.) The modified mechanism and the simultaneous application of anti-avoidance legislation in a multiple-tier structure

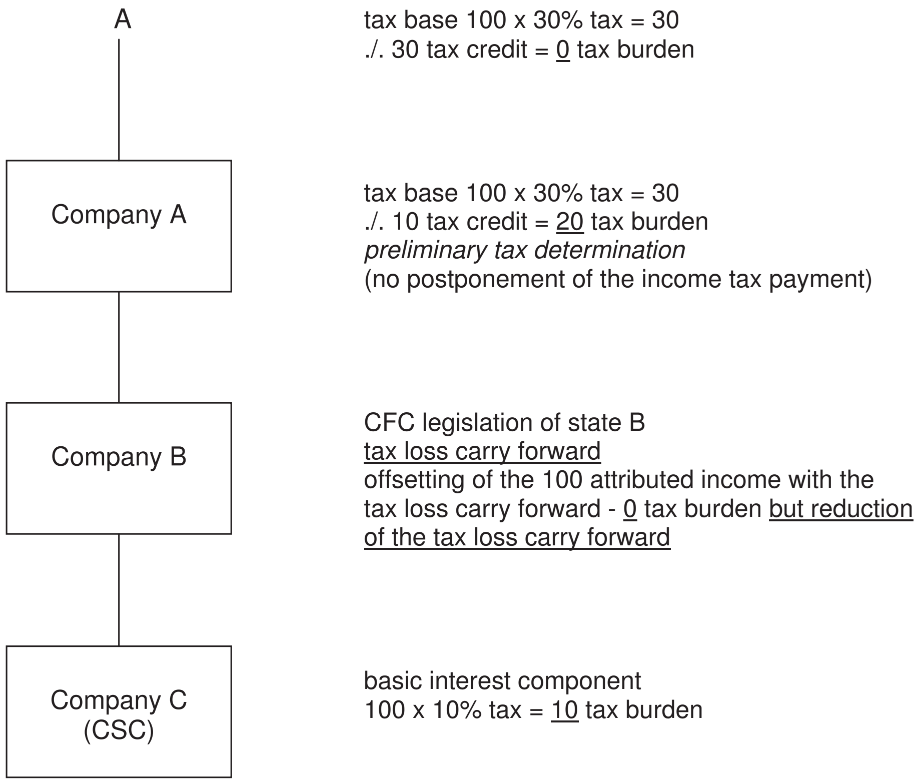
The system of an alternative anti-avoidance legislation should be prepared for the simultaneous application of other anti-avoidance regimes, at least inasmuch as it refers to the same amount of allocable income. Based on the earlier examinations, it is the state of the shareholder on a higher tier which should take into account a comparable legislation - and therefore the income taxation - on a lower tier. However, this should not be limited to a system which focuses on the current attribution of income (e.g. CFC rules) but also on a system which taxes the subsequent distribution on a lower tier according to the credit method instead of the exemption method. What was mentioned above with respect to losses is equally relevant in a structure in which a third state is involved (in addition to the state where the entity is established and which carries on the tainted activities). Overall, it should be very clear that the application of a system which is based on the current taxation of income derived through another entity can quite easily lead to a substantial double taxation of income in a multiple-tier structure. It is therefore of utmost importance that the legislation provides for an appropriate relief from double taxation. The system should by no means be restricted to a specific tax period, as is very often the case, but should follow a more flexible approach - based on the tax credit mechanism described above.

<u>Figure 25:</u>



The mechanism applied in the example follows the pattern outlined above. State A provides an ordinary tax credit up to the amount assessed for company A. The exceeding amount of 5 percent of the taxable income cannot be credited. In effect, the taxable income of 100 Euro is subject to an overall income taxation of 35 percent. It is important to note, however, that the income of 100 Euro is most likely not identical to the total amount which is subject to taxation in state C and subject to CFC taxation in state B. It is just the overlapping amount which reflects the basic interest component and which is - in this example - subject to income taxation in all of the three states. Although the tax base in state C and state B might be higher, the exceeding amount of income is not subject to income taxation in state A and remains, therefore, unaffected. Clearly, this is one of the rather less complex situations since the current attribution of income takes place in the same tax period. The situation becomes more difficult in an alternative scenario where it is assumed that company B has a tax loss carry forward available and the attributed income (based on the CFC legislation of state B) is to be offset with the tax loss carry forward. In such a scenario, the anti-avoidance legislation of state A should strictly follow the procedure which was described above for tax losses in state A and state C.

<u>Figure 26:</u>

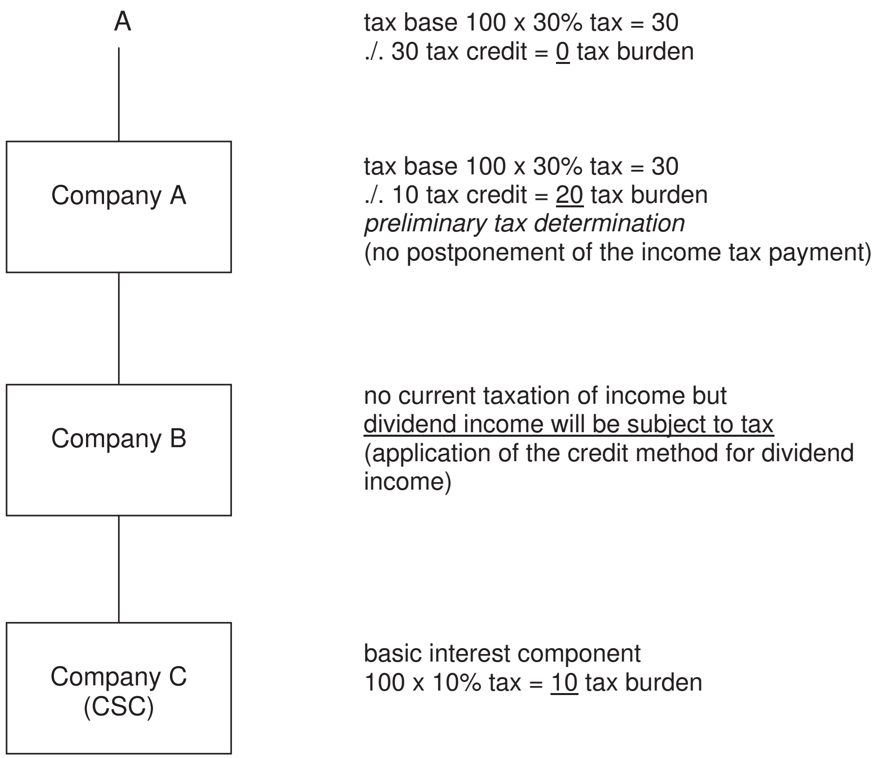


The fact that the income is attributed to company B and offset with the tax loss carry forward may lead to a double taxation of income in subsequent tax periods if - at the same time - the income is currently attributed to company A.[66] As soon as the tax loss carry forward is utilised, the formerly attributed income will be subject to tax in state B. Leaving aside a possible interest advantage which may exist through the timing difference between the year in which the income is attributed and the year in which the income tax is actually payable, and under the assumption that the 10 percent income tax imposed in state C can be deducted from the attributable income in state B, the future income tax burden in state B in relation to the formerly attributed income would be 31.5 percent.[67] Hence, without any adjustment of the preliminary tax determination in state A, the same amount of income would lead to a taxation in state C of 10 percent, in state A of additional 20 percent and in state B of 31.5

[66] Leaving aside the fact that a double taxation may already exist in state B because of the non-existence of a tax credit for the income tax imposed in state C (in the absence of a roll-over system).
[67] 90 Euro (100 Euro minus 10 Euro) x 35 percent corporate income tax rate in state B.

percent, i.e. a total of 61.5 percent which is just caused by the current attribution of income and without taking into account any potential consequences which may come up - in addition - as soon as the underlying income is actually distributed in subsequent years. The anti-avoidance system applied in state A should therefore clearly provide for a subsequent adjustment of the preliminary tax determination as soon as company B starts paying income tax on its positive income in order to avoid the massive over-taxation of income. The respective adjustment would then lead to an income tax burden of zero in state A (for company A and individual shareholder A). In this case, the income will still be taxed with 41.5 percent, which is more than in a situation where no tax loss carry forward is involved, but this is solely due to the non-crediting in state B of the 10 percent income tax imposed in state C.[68]

<u>Figure 27:</u>



The problems involved in this example are quite similar to the problems in the example above. At the moment of income allocation to company A, there will be no

[68] In a "perfect system" state B should take into account the 10 percent tax imposed on the income derived in state C to avoid any unnecessary double taxation of income. However, if this is not the case, the CSC legislation in state A has to step in and provide for a relief from double taxation. The reason is that the proposed system should not lead to a penalisation of foreign investments. Moreover, from an anti-avoidance perspective there is no need to refrain from a crediting in state A.

double taxation. The latter will only occur as soon as the income generated by company C is actually distributed to the shareholder in state B. The legislation of state A should therefore provide for an adjustment of the tax assessment of company A as soon as the profit distribution of company C is subject to tax in state B. This will have the effect that the basic interest component is subject to an income tax of 25 percent (35 percent minus 10 percent tax credit) in state B and, in turn, the income tax will be reduced to zero in state A. The overall tax burden imposed on the income will finally amount to 35 percent - which reflects the higher corporate income tax rate of state B. Needless to state that the mechanism is equally required for the general application of the credit method in state B and for an anti-avoidance approach which switches from the exemption method to the credit method only under certain circumstances, e.g. if company C derives income from certain activities.

In principle, what was described above with respect to the difference between the actual income derived by company C and the basic interest component is equally relevant for those cases in which - in addition to the basic interest taxation - an income allocation according to CFC rules (e.g. in state B) takes place. Again, the focus must still be on the basic interest component and may not be influenced by a higher or lower income determined in states B and C (apart from the preliminary tax determination and a possible postponement of tax payments).

	Year 01	Year 02	Year 03
income of company C	300	(100)	600
CFC taxation in state B (subject to 35% income tax)	300	0	600
basic interest component	100	100	100
taxation of company A (without any postponement) 100 x 30% = 30 ./. 30 tax (max.)	0	-	-
preliminary tax company A (subject to postponement)	-	30	-
final calculation for company A 200 x 30% = 60 ./. 60 tax (max.)	-	-	0

As a result, the corporate income taxation in state B is taken into account in the same way as the corporate income taxation in state C. Due to the fact that the tax rate in state B exceeds the tax rate in state A, the final tax burden in state A is zero. This is an appropriate result since the anti-avoidance legislation should not have the effect of an over-taxation of income.

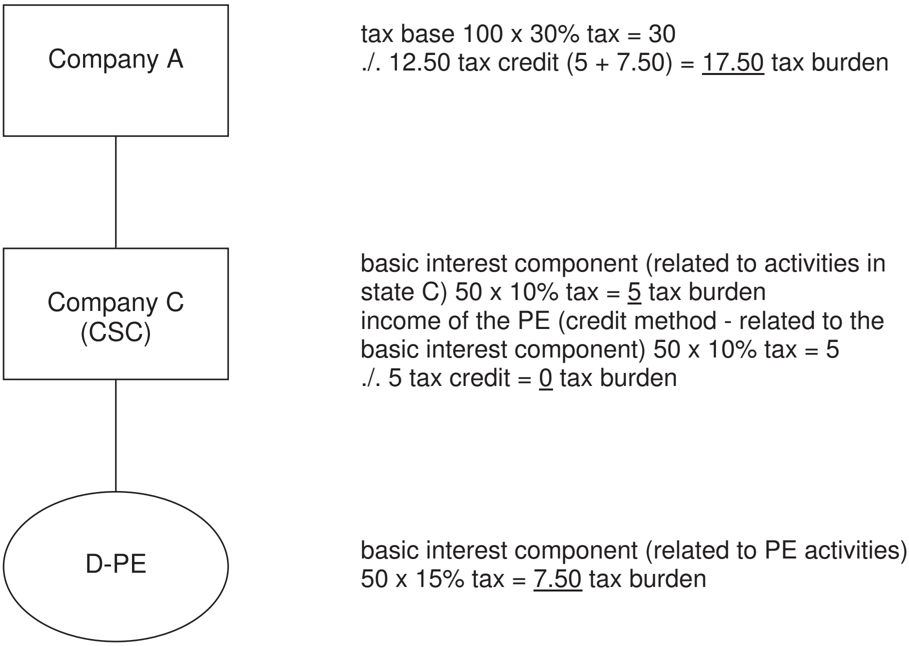
f.) The modified mechanism and classification conflicts

It was outlined in chapter 6 that the application of CFC rules to transparent and non-transparent entities (and permanent establishments) - which is the case in some states - as well as the classification conflicts in this context may lead to a double taxation of income. However, if the principles described above are applied consistently, these conflicts should not cause serious difficulties within the proposed concept of an alternative anti-avoidance legislation. For example, if state A classifies company C as a non-transparent legal entity, but subsidiary company B (in the structure outlined above) considers company C to be a transparent entity, the risk of double taxation mainly depends on the method of avoidance of double taxation in state B. If the latter state applies the exemption method, the income will not be subject to double taxation at all. However, if state B does not exempt the income of the transparent entity but applies the credit method for the avoidance of double taxation, it is obvious that state A should credit the amount of income tax imposed in state B in the same way as previously described in case of the simultaneous application of a CFC taxation in state B. In this particular situation, there is no significant difference with respect to the crediting of income taxes imposed in state B on income of a transparent entity (from the perspective of state B) and the income taxes imposed in state B on attributed income according to a CFC regime.

g.) The modified mechanism and the application to permanent establishments and transparent entities

What is true for the classification conflicts is equally true for permanent establishments and entities which are classified as transparent by all of the states involved, i.e. where no classification conflict exists. In those cases, the basic interest component may have to be determined for the activities of the legal entity *and* the activities which are carried on through the PE (PS). Here, it is important to identify the income taxes imposed on the respective income and the respective treatment of the PE (PS) income in the state of the legal entity (in case the PE (PS) state deviates from the state of the legal entity). In other words, the general principle described earlier must be applied: the higher-tier state must take into account the treatment on the lower group level. Again, the question whether the legal entity in question applies the credit method or the exemption method for the income derived by the PE (PS) is of particular importance for the crediting of the income taxes in the state which applies the current taxation of the basic interest component. In principle, the outcome should not be different from a situation in which the tainted activity is carried on by two lower-tier legal entities (which are non-transparent). This can be illustrated by the following example (the individual shareholder A is again left aside for the reason of simplification).

Figure 28:



In this example, the tainted activities are carried on by company C in state C and in state D - in the latter case through a PE. It shall be assumed that state C applies the credit method for the avoidance of double taxation caused by the inclusion of the PE income in the domestic tax base. The income derived through the PE is subject to income taxation of 15 percent in state D and income taxation of 10 percent in state C. An ordinary tax credit system would therefore result in no additional income taxation in state C, i.e. the 50 Euro of basic interest income derived in state D are subject to an overall income tax burden in states C and D of 7.50 Euro (15 percent). The basic interest income derived in state C is subject to 10 percent taxation. If it is assumed that it is also 50 Euro, it would result in a 5 Euro income tax burden imposed in state C. In state A, the basic interest income of 100 Euro (50 Euro related to state D and 50 Euro related to state C) is subject to a 30 percent income taxation. However, due to the crediting of 7.50 Euro income tax (state D) and 5 Euro income tax (state C) the additional taxes imposed in state A and payable to the tax authorities are only 17.50 Euro. Hence, what remains is a total tax burden of 30 percent. In fact, the final result would not be different if state C does not apply the credit method but the exemption method, since the tax credit in state A would also be 12.50 Euro. In this case, the outcome would be comparable to a situation in which the tainted income is derived by two separate legal entities in state C and state D (without any PE).

The separation of the activities of the PE from the activities of the headquarter company is not only important for the exact determination of the income tax burden, but it is especially required in those cases in which either the PE or the headquarter company (or both) suffer tax losses. This will usually not be an issue if the PE and the headquarter company are located in one and the same state, but will be of utmost importance if two (or more) tax jurisdictions are involved - like in the example above. Here, it is advisable to follow an approach which is based on the strict separation of activities in the same way as in case of separate legal entities. In other words, the basic interest calculation should be made, at least, on a country by country basis, no matter whether a legal entity is involved or a PE (PS). Of course, if there is more than one entity / PE which carries on the activities in the respective state, the calculation is to be made for each of the respective entities / PE. The equalisation of legal entity and PE - for purposes of income attribution and credit mechanism - is certainly the best way, in my opinion, to avoid the over-taxation of income and to ensure the appropriate crediting of income taxes.

9.4.8. The Treatment of Subsequent Profit Distributions

The treatment of dividends should be strongly dependent on the previous taxation of the attributed income. Otherwise, there is an increased likelihood of a double taxation of income, first, by attributing and taxing the basic interest component in the hands of the shareholder and, second, by taxing the subsequent dividends which theoretically also encompass - indirectly - the basic interest component. Any partial relief or any restriction in the form of a time limit, as is the case under some of the CFC regimes, is by no means acceptable. This might otherwise lead to a treatment of the particular income component which is worse than the treatment of any other type of income generated - directly or indirectly - by the shareholder. Again, the current taxation of income should not have any other effect than the immediate inclusion of the income component in the domestic tax base - without any negative “side effects.” In the alternative system, however, the avoidance of double taxation caused by subsequent dividend payments requires a separate approach depending upon whether the recipient of the dividend payment is a legal entity or an individual shareholder.

a.) The subsequent profit distributions to a legal entity

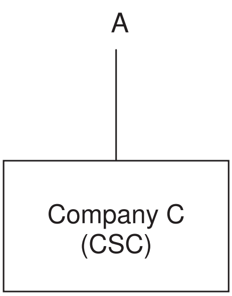
Based on the approach outlined above - which involves company A as the corporate shareholder in the service company C - the simplest way would be to exempt the subsequent profit distribution of company C from any income taxation in the hands of the corporate shareholder up to the amount of previously attributed income.[69] For example, if the basic interest income of 100 Euro was already taxed in state A with 30 percent (30 Euro minus 10 Euro tax credit = 20 Euro), a subsequent distribution of 100 Euro should not be subject to corporate income taxation in state A. However, it should be clear, as already stated in previous chapters, that the exemption should not be limited to 95 percent of the dividend distribution but should encompass the complete 100 percent. In this situation, there is - in the same way as in case of the existing CFC regimes - no necessity and no justification for the treatment of a certain pre-determined percentage as taxable income in order to cover, for example, the expenses related to income exempt from taxation in state A. The reason is that the subsequent exemption of the dividend payment - to the extent it refers to the previous income allocation - is just a necessary means for the avoidance of the double taxation of income, i.e. the income is already taxed in state A and, for this reason, the related expenses should be deductible without any limitation.

[69] If the dividend distribution is not *in general* exempt from income taxation. In case of a general exemption there is no need for a separate rule on a corporate level.

b.) The subsequent profit distributions to an individual shareholder

The fact that the income is allocated not only to the corporate shareholder but, in addition, to the individual shareholder - combined with the application of a (preliminary) flat income tax which is derived from the domestic corporate income tax rate - requires a different approach regarding the subsequent dividends. The concept mainly depends on the general system of dividend taxation of the shareholder in the residence state. For example, if the latter state follows a tax credit system for individual shareholders, the dividend income will be taxed at the personal income tax rate of the recipient. Here, the crediting of income taxes may not be limited to the corporate income tax imposed on the income of the dividend paying company but should take into account the (additional) income taxes paid in the residence state of the shareholder on the previously attributed income. The same should be true if the residence state does not provide for a tax credit. In such a case, the dividend income itself might be taxed at reduced rates which typically reflect the fact that the income was already subject to tax on a corporate level, e.g. under a “half- or partial income tax” system. In those cases, the dividend income should be taxed under the regular (reduced income tax) system, but the income taxes imposed on the previous income attribution should be taken into account, too. The avoidance of double taxation and, in particular, the equal treatment of current and non-current income attribution requires the system to provide for a full tax credit and not just an ordinary tax credit. This should not be too difficult for the residence state of the individual shareholder since the full tax credit is solely related to the reimbursement of *domestic* income taxes which were imposed at an earlier point in time.

Figure 29:



Year 01	Year 02
tax base 100 x 30% tax = 30 ./. 10 tax credit = 20 tax burden	tax base 90 x 25% tax = 22.50 ./. 20 tax credit (01) = 2.50 tax burden
basic interest component 100 x 10% tax = 10 tax burden	profit distribution of the net amount of the basic interest component 100 ./. 10 = 90

In this example, the subsequent dividend payment will be taxable in state A pursuant to the regular system of dividend taxation, e.g. with a reduced tax base or - like in this example - with a reduced tax rate (e.g. 50 percent income tax rate x ½). However, in addition to the regular treatment in the hands of shareholder A, the previous income taxation in year 01 must be taken into account. In my opinion, the simplest way is to provide for a full tax credit of the 20 Euro income tax imposed in year 01 which leads to an overall tax burden in state A of 22.50 Euro (on 90 Euro dividend income).[70] Of course, only 90 Euro may actually be distributed related to the basic interest component of year 01. Thus, the full tax credit should be provided in case of a 90 Euro dividend distribution and not only in case of a distribution which is as high as the previous gross income attribution. Such a mechanism would lead to a comparable treatment of the alternative anti-avoidance legislation (after profit distribution) and the regular system of profit distribution in the state of the shareholder A. The important difference, however, is the “timing effect”, i.e. the basic interest component will be subject to an immediate taxation in state A but the final tax burden will only be determined as soon as the actual profit distribution - related to this particular portion of income - takes place.[71] If the tax rate in year 02 is only 15 percent (instead 25 percent), the crediting of the 20 Euro income tax will lead to a reimbursement of 6.50 Euro and therefore to a final tax burden of 15 percent on 90 Euro (13.50 Euro). Such a mechanism is especially important in case of tax losses of shareholder A in the year of profit distribution if the dividend income is offset with the tax losses and no income tax will be imposed in year 02 (but in subsequent years). Only a full reimbursement of the previous income taxes will lead to a neutral and undistorted tax result - but without jeopardising the aim of the anti-avoidance legislation. Of course, the aforementioned principles can be equally applied in a multiple-tier structure.

[70] Under the assumption that the half- or partial income tax system is only taxing the actual amount of distribution (without any tax gross-up). In any event, the full tax credit of 20 Euro does not require - under the CSC system - the gross-up of the dividend income from 90 Euro to 100 Euro.

[71] As already described earlier, the income allocation is to be made to the ultimate domestic shareholder and subject to a flat income tax (separate schedule). This can lead to the consequence that no additional income tax is imposed on this first step of allocation, but only on the second step (actual distribution). From my perspective, this is a consistent approach which avoids any distortion caused by the application of a higher personnel income tax rate on the attributed income (first step) under a progressive tax system. In my view, this does not open the possibility for (unacceptable) deferral planning, because it keeps the tax rate applied to the domestic individual shareholder at least on the level of the domestic legal entity (no matter whether the income was derived through a domestic CSC or a CSC in another state).

<u>Figure 30:</u>

	<u>Year 01</u>	<u>Year 02</u>
A	tax base 100 x 30% tax = 30 ./. 30 tax credit = <u>0</u> tax burden	tax base 70 x 25% tax = 17.50 ./. 0 tax credit = <u>17.50</u> tax burden
Company A	tax base 100 x 30% tax = 30 ./. 10 tax credit = <u>20</u> tax burden	full exemption of the dividend income / assumption: distribution to shareholder A = 70 (instead of 90)
Company C (CSC)	basic interest component 100 x 10% tax = <u>10</u> tax burden	profit distribution of the net amount of the basic interest component 100 ./. 10 = 90

Following the mechanism described above, the dividend income should be completely exempt from taxation in the hands of company A. The subsequent distribution to shareholder A should be taxed pursuant to the regular system, but by providing a full tax credit for the income taxes already paid in state A. In the example, the income taxes imposed on the income attributed to shareholder A in the year 01 are zero and therefore no credit is available in year 02. Theoretically, however, the full tax credit (in those cases in which an actual tax credit is available) should be provided for a dividend of 70 Euro (and not only in case of a dividend of 90 Euro or 100 Euro). The reason is that the additional taxation on the level of company A should be taken into account for this calculation as well. The basic interest component is therefore reduced by the amount of income tax in state C of 10 Euro and in state A of 20 Euro. The net amount is therefore only 70 Euro. This is what theoretically remains for any (final) profit distribution to the individual shareholder A. If, in the example, the subsequent distribution of company A is 90 Euro, the amount of 70 Euro would still be the amount which allows the complete crediting of previous income taxes paid by the individual shareholder A, and the exceeding amount of 20 Euro would be subject to regular dividend taxation (without any further income tax credit). For dividend payments of company A which are below 70 Euro, a pro rata tax credit shall be provided.

9.4.9. The Treatment of a Subsequent Disposal of Shares

Obviously, what is true for subsequent profit distributions should be equally true for the disposal of shares after a current income attribution, i.e. any double taxation of income should be strictly avoided. An economic double taxation might occur if the income is attributed to the shareholder - without any actual distribution - and is therefore subsequently included in a possible capital gain realised by the disposal of shares, too. Another aspect which could play a role if the shares are sold to a third party is a preliminary tax determination which was subject to postponement, e.g. because of the fact that the CSC suffered tax losses. Here, the capital gain realised must be taken into consideration for the question whether the negative result of the service company - which allows the postponement of taxes imposed on the basic interest component - is offset by the subsequent positive income. The latter income would normally trigger the payment of the income taxes to the tax authorities to the extent the positive income exceeds the negative income. Therefore, in case of a disposal of shares the focus cannot only be on the actual result of the service company in question but the “additional” (future) positive income which is already prospected in the higher share price must be taken into account as well. This additional income included in the share price is therefore of relevance for the question whether the preliminary income tax is now payable to the tax authorities - because the overall positive income exceeds the amount of negative income - or whether an adjustment has to be made since the source of income is not existent anymore and the positive result is not high enough to cover the basic interest component calculated on a yearly basis.

	Year 01	Year 02	Year 03
income of company C	(100)	(100)	
basic interest component	100	100	
capital gain realised on January 1 of the year 03	-	-	100
preliminary tax company A (subject to postponement)	30	30	-
final calculation for company A 100 x 30% = 30 ./. 10 tax credit	-	-	20

In this example, company C generates a negative income in year 01 and year 02 and no income tax is imposed in state C. For this reason, the assessment of the basic interest component is made on a preliminary basis and is subject to postponement. At the beginning of year 03 the shareholder realises a capital gain of 100 Euro from the disposal of the investment. Thus, despite the negative income, the final act - namely the disposal of the shares - realises an overall positive income for the shareholder. For this reason, a final taxation has to be made. Following the mechanism described earlier in this chapter there should be no income tax credit, because no actual income tax is paid at that point in time in state C. However, due to the fact that the shares are sold to another party and therefore the source of income will not be existent anymore for company A, a decision has to be made regarding the postponement of taxes and the question whether a tax credit is ultimately to be granted or not. In this particular case, it seems to be acceptable to deduct the theoretical income tax which might be imposed in state C on that income in subsequent years in order to avoid any double taxation of income (the underlying rate should be the rate which is applicable in year 03). If it is assumed that the purchaser of the shares is the unrelated company AA, the further procedure should be as follows:

	Year 03	Year 04	Year 05
income of company C	0	100	600
basic interest component	100	100	100
preliminary tax company AA (subject to postponement)	30	-	-
preliminary tax company AA (without any postponement)	-	30	-
final calculation for company AA 300 x 30% = 90 ./. 30 tax (in 05)	-	-	60

Under the assumption that the tax losses of company C can be utilised after the change in ownership in the shares, another more differentiated approach is required. The income of company C in the year 03 is zero. For this reason, the income tax on the basic interest component is subject to a preliminary tax determination and the payment may be postponed. The income in the year 04 is exactly as high as the basic interest component. However, still no income tax is payable on the income of 100 Euro since the positive income is to be offset with the existing tax loss carry forward of -200 Euro. The income tax determination in state A should therefore also be made on a preliminary basis in order to ensure that the assessment may be adjusted as soon as taxes are imposed in subsequent years. However, in contrast to the treatment in the year 03 there is no necessity to provide for a postponement of the income tax payment in state A. Even though the loss of -200 Euro originates from the activities of company C, there is absolutely no necessity to grant the relief of a later tax payment. This is mainly due to anti-avoidance considerations in order to avoid that tax losses are transferred from one shareholder to another shareholder just as tax planning tools. Again, there is no question about the fact that the losses should still be available after the transfer of the shares and that the income tax burden in subsequent years may lead to a correction of the preliminary determination of the income taxes imposed on the basic interest component. But this does not necessarily require the postponement of income taxation in state A. As a general rule, the postponement should be provided to the extent that the basic interest income exceeds the actual income derived during the period of shareholding.

With respect to the question whether capital gains realised by the seller should be exempt from taxation or not it is again important - similar to the treatment of subsequent profit distributions - to follow a separate approach for capital gains of corporate shareholders and individual shareholders.

a.) The subsequent disposal of shares through a legal entity

The capital gains realised on a corporate level should be exempt from taxation as far as the income was previously attributed to the shareholder before the disposal of the shares. In other words, the income which was already subject to current taxation should not be taxed again in the context of the disposal. This is not really a problem for those states which provide for a general exemption of capital gains, as long as it is completely exempt, i.e. to 100 percent. Any limitation to a 95 percent exemption is not sufficient and has the consequence of a partial double taxation (see the previous comments in this respect). For states which do not provide for an exemption of capital gains it is necessary to deduct the formerly attributed income from the tax base of the income from capital gains. For example, if 300 Euro were currently attributed to the corporate shareholder during the period of shareholding and the capital gain realised by the disposal of the shares is 500 Euro, the taxable income of 500 Euro should be reduced by the formerly attributed 300 Euro. Thus, only 200 Euro are finally subject to capital gains taxation. However, if the attributable income of 300 Euro was already distributed to company A and the dividend income was treated as tax exempt income (before the disposal and pursuant to the mechanism described above), there is no need for an additional exemption since there will be no double taxation of income. In principle, such a procedure is not only relevant in case of the direct sale of the shares in company C, but is equally relevant for the sale of intermediate shareholdings. This, however, should not be a problem since the amount of adjustment is in any case connected to the previous income attribution - irrespective of whether it is a direct or indirect shareholding.

b.) The subsequent disposal of shares through an individual shareholder

The capital gains realised through the disposal of shares in the hands of the individual shareholder are to be treated similar to the dividends received by an individual shareholder. That means the capital gains should be taxed according to the regular system in state A and should not be exempt from taxation (if it is not already exempt according to the regular system). The income taxes imposed on the previously attributed income have to be credited against the income taxes imposed on the income from capital gains. An exceeding tax credit is to be reimbursed (full tax credit system). This ensures that the capital gains taxation is largely unaffected by the former income attribution and no distortions will exist because of the preliminary flat income tax which was imposed on the attributed income. The final income tax burden will represent the personal income tax rate of shareholder A. Clearly, if a profit distribution takes place before the disposal of the shares, the income tax on the basic interest component will be credited first against the income tax on the profit distribution. Only the attributed income (and the respective credit) which is not “eliminated” through profit distributions will be taken into account for the subsequent capital gains taxation. The question could be raised whether the credit should be separated in those cases in which only a certain percentage of the shares is sold, i.e. the credit is equal to the percentage of disposal, or whether the credit should be granted up to the amount of income of capital gains - irrespective of the percentage of shareholding. In the latter case, the total amount of credit will be utilised as soon as the disposal of (part of) the shares results in a capital gain which is as high as the formerly attributed income less the amount of income tax paid in state C (or in the intermediate state B). Both approaches can be applied in practice, although it is not completely ruled out that the second-mentioned approach might - depending on the tax legislation of state A - provoke some tax planning structures (step-up structures). However, the risk is certainly minimised through the percentage of shareholding generally required and the constructive ownership rules.

9.4.10. Exemptions from CSC Taxation

The fact that the basic interest taxation only focuses on services which provide capital to other parties already considerably limits the scope of application. Nonetheless, the compliance burden connected with such legislation should not be underestimated and should therefore be proportionate to the purpose followed by such a regime. In this respect, it should not be overlooked that the legislation is applicable to resident and non-resident taxpayers and simultaneously to corporate and individual shareholders. Hence, it is obvious that such far-reaching legislation should not be applied to each and every capital service provided by the respective legal entity, e.g. if the capital services are of minor importance in the overall context and subordinate to the other activities carried on by the taxpayer. Another exemption which is also granted under the existing CFC regimes is the exemption of services mainly provided to unrelated parties.[72] Even though the economic aspects of the basic interest taxation are equally relevant in the latter case, the anti-avoidance aspects are less important if, for example, the capital services are provided by banks, insurance companies, major leasing companies et cetera. The compliance aspects may therefore support an exemption in those cases as well. In the following, the proposed exemptions under the alternative regime will be outlined.

9.4.10.1. Exemption Based on a Property-Ratio

The basic interest taxation focuses on a rate of return calculated on tainted property and ignores, at least to a certain extent, the actual (total) income derived from the tainted activities.[73] The fact that the property of the legal entity plays a key role in the determination of the tax base suggests that it may also be used as the decisive factor - or one of the decisive factors - for the answer to the question whether the activity should be exempt from basic interest taxation or not. If the tainted property is only of minor importance within the overall activity of the respective entity, it is certainly acceptable to refrain from the current taxation of the basic interest component. A simple method can be the comparison of the book value of the tainted property with the book value of the non-tainted property, and if the latter exceeds a certain percentage of the total property of the legal entity, an exemption should be granted. In other words, if a substantial part of the tangible and intangible property - based on book value - in the balance sheet of the legal entity is employed for non-tainted activities, there will be no current taxation of income. Clearly, one could argue that it might be better to take into account the adjusted value of the property for the comparison (which was described earlier as the calculation basis). However, in my opinion, the basis for the comparison should be as simple as possible since it theoretically has to be applied to a great number of cases. Here, it is important to identify immediately whether the investment should be exempt from current taxation or not. Thus, I would even suggest concentrating just on the book value of the property in the financial statement of the company at the beginning and at the end of

[72] See in this regard also section 9.3.8.4.
[73] This, however, is only true as long as the actual income derived from the service activities exceeds the basic interest component. However, if the income is lower, e.g. in case of tax losses, this fact will be taken into account by way of postponing tax payments and determining tax assessments on a preliminary basis.

the financial year in question. If the property ratio is fulfilled at the beginning *and* at the end of the year, there will be no current taxation of income. The verification is to be made on a yearly basis. Such an approach ensures that only entities which heavily rely on the provision of capital services come within the scope of the current taxation of income. I consider the exemption rule based on a property-ratio as the basic rule for the decision whether the activity of the company in question should be subject to current taxation or not. However, since the rule theoretically has to be applied to each and every investment, the taxpayer has to submit a tax return if the property-ratio *is not fulfilled* instead of applying for an exemption on a regular basis. The decisive element, of course, is the percentage which should be applied. In my opinion, the percentage should be in a range between 50 percent and a maximum of 75 percent of the total book value. That means, if the non-tainted property exceeds 50 percent (or alternatively up to more than 75 percent) of the total property - based on the book value - there should be no current taxation of income.

9.4.10.2. Exemption Based on an Income-Ratio

It may be the case that a company combines a highly profitable activity which requires a relatively low investment in tangible and intangible property (e.g. consulting services) with capital intensive tainted services. Here, the reliance on the investment in property will most certainly lead to a current taxation of income based on the property-ratio even though the actual income derived by the entity might theoretically mainly consist of income derived from the non-tainted activity. In those cases, it may be justified to provide for an (additional) exemption from current taxation - even though the property-ratio is not fulfilled - if the taxpayer can provide evidence that the actual income from non-tainted activities exceeds the income from tainted activities (including all income components). The threshold when the exemption is to be granted could be - similar to the property-ratio - in a range between 50 percent and 75 percent. In other words, if the income from non-tainted activities exceeds 50 percent (or alternatively up to more than 75 percent) of the total income, the exemption is provided even if the property-ratio is not fulfilled. Similar to the property-ratio, the calculation is to be made for the income derived within the respective financial year in question and it should be based - similar to the existing CFC rules - on the tax rules of the state which applies the legislation. In addition, certain extraordinary elements would have to be eliminated for the comparison (e.g. capital gains from the disposal of assets).

9.4.10.3. Exemption Based on the Classification of the Service Recipients

An exemption which is based on the classification of the recipients of the services as related or unrelated party may be justified by the reduced risk of tax avoidance and the limitation of compliance costs. It would be highly complex, time consuming and expensive to calculate the basic interest component, for example, on property held by banks, insurance companies and major leasing and rental companies. The latter companies would very often not fulfil the exemption requirements under the property-ratio and the income-ratio since they provide exactly those services which are in the focus of the basic interest taxation. Given the immense investments in those cases, it may be acceptable to set the threshold higher than the minimum percentage in case of the property-ratio and the income-ratio. Thus, the exemption may be granted if the tainted services provided to *unrelated* parties encompass more than 75 percent of the total tainted services provided to related and unrelated parties. Here, the question arises whether more than 75 percent should be related to service contracts, investment in property, or income. In my opinion, either the percentage of the property of the company or, alternatively, the percentage of income may be referred to. However, the reference to the percentage of income might be simpler and is therefore to be preferred. The number of service contracts is most certainly not the appropriate basis for this decision since it may open the possibility of influencing and even circumventing the current taxation more easily than in the other cases (e.g. by providing a great number of capital services to unrelated parties which require a relatively modest capital investment and by providing few capital services to related parties which require substantial capital investments), and it might therefore lead to unacceptable distortions.

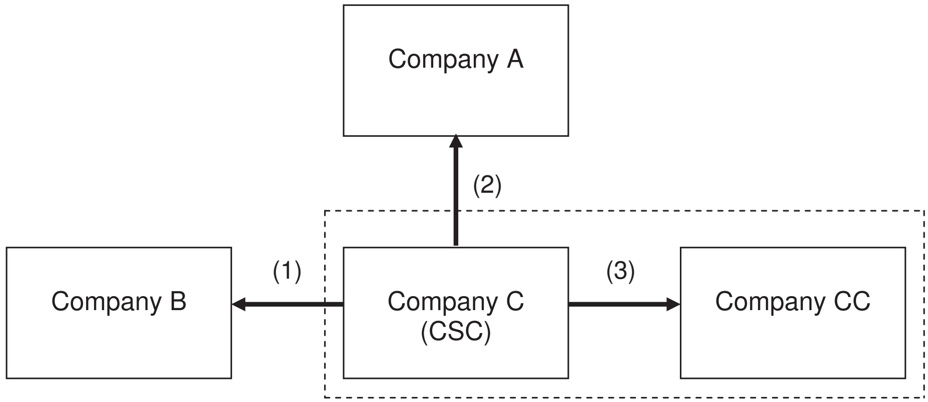
9.4.10.4. Exemption Based on a General Financial Threshold

It is certainly recommendable to provide, in addition, for an exemption which refers to an *absolute* amount of tainted investment which is unconnected to a property-ratio or income-ratio. This ensures that not each and every minor amount of tainted investment is subject to current taxation which is certainly required from an administrative perspective. In this respect it could make sense to refer to the net calculation basis, i.e. the (adjusted) book value of the tainted property minus the portion of debts allocable to the investment (= net calculation basis). If the net calculation basis does not exceed a certain financial threshold at the beginning and at the end of the financial year, there will be no current taxation of income. From my perspective, the threshold could be set within a range of 100,000 Euro and 500,000 Euro. Even though the proposed range seems to be relatively high compared to the thresholds provided for in the existing CFC regimes, one has to be aware of the fact that the scope of application is much broader since the legislation is not restricted to low-tax income derived by a foreign company but is instead applicable to foreign and domestic tainted activities without any reference to the tax rate.

9.4.10.5. Exemption Based on Income Taxation at Source

The basic interest component is calculated on the tainted property of the company and is therefore, in principle, not directly connected to the actual income derived by the tainted activities. Based on the general principles outlined in previous chapters, it seems to be rather evident that the basic interest component should not be allocated to the shareholder if it is subject to source-based taxation in the state where the recipient of the services carries on its income-producing activities, and if the income is completely tax exempt in the state of the service provider. In such an optimal scenario, there is no need for any current taxation of income, neither from an equity and economic perspective nor from an anti-avoidance perspective. Even though the system of income allocation would in any event be subject to limitation to the positive taxable income it is nonetheless required to provide for an explicit exemption in case of a strict source-based taxation. In the latter case, the actual income might even be higher than the basic interest component, but is not subject to any residence-based taxation in the state of the service provider. However, it must be kept in mind that a strict source-based taxation of the services in question is not provided for under the OECD-MTC.

Figure 31:



Explanations:

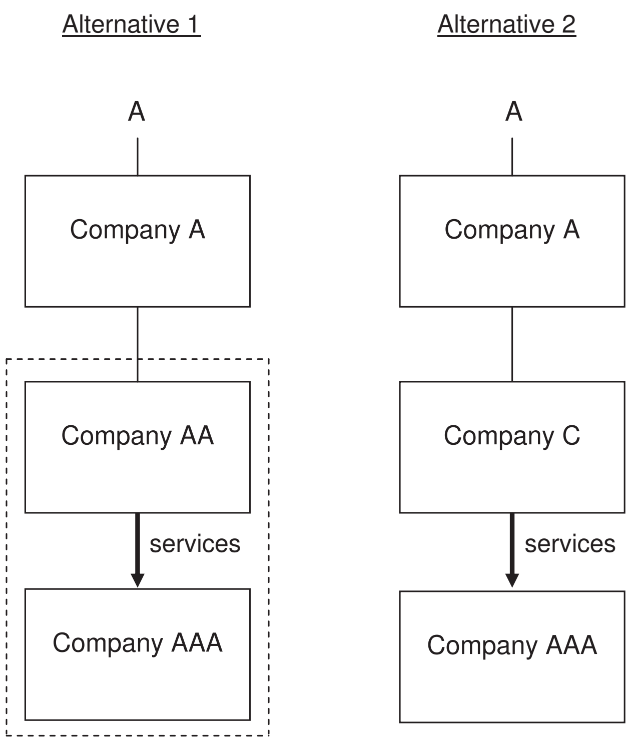
(1) Inter-company services provided by company C to company B.
(2) Inter-company services provided by company C to company A.
(3) Inter-company services provided by company C to company CC (no cross-border services).

In the example, the services of company C are provided towards companies A, B and CC. Under the assumption that the services have to be classified as tainted activities, and that the services are subject to a residence-based taxation in state C, the basic interest component will be calculated on the tainted property of company C and will be attributed to the shareholder in state A. The residence-based taxation of the tainted activities is clearly supported by the OECD-MTC. However, if it is assumed that the double tax conventions between the states A-C and B-C provide for a strict source-based taxation in the state of the recipient of the services, there should be no income allocation of the basic interest component. Thus, the underlying property for the services (1) and (2) should be excluded from the calculation basis. What remains is the taxation of the services provided to company CC (3). In the latter case, the services are rendered in a merely domestic context and will, therefore, be subject to income taxation in state C. However, the question arises whether an exemption may be granted in those cases, too, in which the state of residence and the state of source are identical, i.e. if the taxation of the tainted income takes place in the state where the income is actually produced. Such an exemption would be supported by the general principles outlined in previous chapters but might be a problem from an EU law perspective. This question will be verified in the following.

9.4.10.6. One Step Further: Exemption for Cases where the State of Source is Identical to the State of Residence?

It was outlined in previous chapters that the taxation in the state where the income is produced is the preferable result from an equity perspective and an economic perspective. It is therefore quite obvious that the question arises whether the current taxation of income should take place in cases in which the service provider and the recipient of the services carry on their income-producing activities in one and the same state. Here, the taxation - even though it may still be based on the principle of residence - is imposed “at the right place,” namely in the state where the income is actually produced. In the example above, this would lead to the result that not only the services (1) and (2) are exempt from the current taxation of the basic interest component, but also the services provided within state C (3). Consistently, it would also result in an exemption of the services provided within state A, e.g. services provided by company A towards another resident company. This, however, is a “delicate” issue from an EU law perspective since it can be argued that the current taxation of income - even if it is limited to the basic interest component - can be seen as a restriction on the exercising of basic freedoms. It is therefore of utmost importance that such restrictive measures are applied in a manner which treats purely domestic transactions comparably restrictive as cross-border transactions. This is the main reason why the proposed anti-avoidance legislation should not make any differentiation between domestic and foreign tainted activities. The provision of an (additional) exemption from current taxation for tainted services which are rendered within the state where the income is actually produced would make perfect sense from a tax policy perspective. However, there can be situations in which such an exemption could result in a restriction of cross-border investments compared to purely domestic investments. This may be illustrated by the following example:

Figure 32:

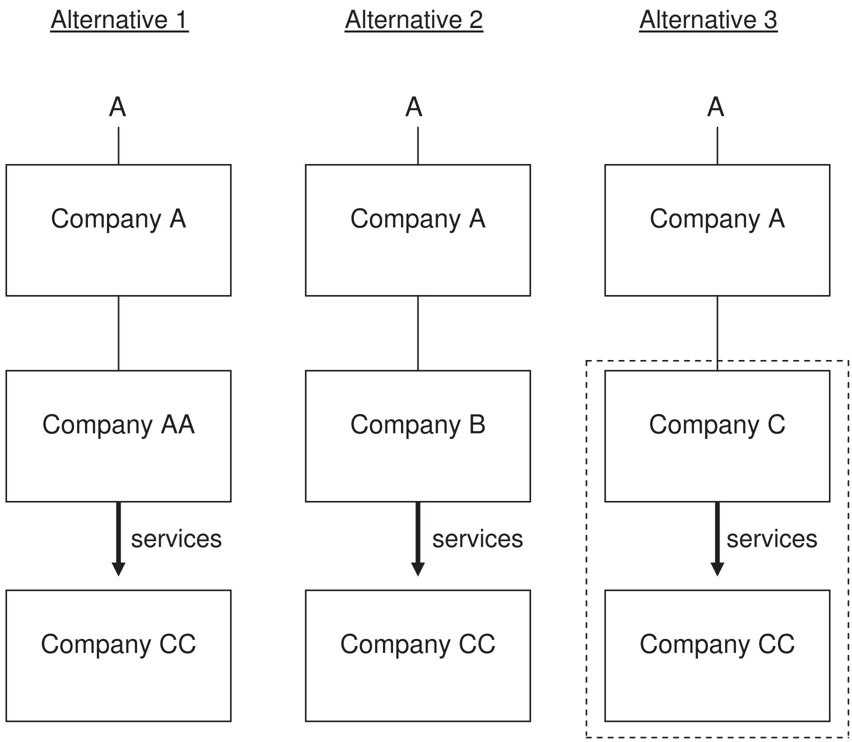


If, in the example, the services provided by company AA (alternative 1) were be exempt from any current income allocation to the corporate shareholder A and the individual shareholder A, it might be argued that this creates an advantage for purely domestic investments compared to cross-border investments (alternative 2) in which the basic interest component would be currently allocated to the corporate and the individual shareholder in state A. Based on the earlier arguments in favour of the current allocation of the basic interest income it may certainly be concluded that this particular transaction, i.e. the equity investment in a foreign company which is subsequently re-located back to the state where the equity investment comes from, is a transaction which strongly supports the argument that the risk-free interest component should be taxed in state A. Not only that it leads to a (limited) taxation in the state where the income is actually produced, it is also of great importance from an anti-avoidance perspective. The non-attribution of the basic interest component would not only shelter the income related to the capital investment from domestic taxation but would also create an additional reduction of the domestic tax base through the acceptance of the service payments as deductible business expenses in state A (which includes again an interest component). However, the mere fact that the equity investment is made by a resident company *and* that the subsequent services are rendered to a resident company cannot be considered abusive. Such a constellation in which the investor and the recipient of the services are resident in one and the same state is quite normal and may not be seen as an indication for tax abuse and tax avoidance. Even if the domestic shareholder and the recipient of the services are one and the same taxpayer, i.e. the recipient of the services (in alternative 2) is company A (or individual A) and not company AAA, this cannot be seen as abusive just due to the fact that the domestic investor is not only a shareholder in the subsidiary company but is, at the same time, involved in a business relationship with the latter company.[74] It is therefore quite obvious - especially from the examinations in previous chapters - that a differentiation cannot be made based on the argument of tax abuse and tax avoidance. The same is basically true with respect to a justification based on the protection of a balanced allocation of the power to impose taxes between Member States. The current taxation of the basic interest component only in case of alternative 2 cannot be explained by the necessity of a symmetrical treatment of income and I do not think that the ECJ would follow such an argumentation (even in case of a limitation to the basic interest component).

However, the question arises whether the alternative legislation could provide for an exemption of the basic interest taxation for services rendered within a certain state (e.g. state C) but without providing the same exemption to cross-border services and to domestic services. In other words, the services provided by non-resident companies to recipients in the same state for an income-producing activity carried on in this state would be exempt from current taxation whereas cross-border services (for example A-C or B-C) and purely domestic services (within state A) are subject to current taxation of the basic interest component. Theoretically, this could lead to an unfavourable treatment of purely domestic services compared to services rendered *within* another state, but it would not lead to an unfavourable treatment of cross-border services (related to Member State A) compared to merely domestic services.

[74] See in this respect also Advocate General Léger, Opinion of the Advocate General (case C-196/04 - *Cadbury Schweppes plc*), paragraphs 106 to 109.

Figure 33:



In this example, the services rendered by company AA and company B are both considered to be tainted activities which are subject to a current taxation of the basic interest component in state A. The services rendered by company C are also considered to be tainted services which, in principle, lead to an attribution of income to the domestic shareholders in state A. However, in the latter case, the services are rendered to a recipient in the same state (company CC) which - in this example - utilises the services for an income-producing activity in state C.[75] From a tax policy perspective, the income could therefore be exempt from domestic taxation in state A. This is not only true for the non-tainted income of company CC but is equally true for the tainted income of company C. It must be noted that state A, in general, does not provide for a more favourable treatment of the cross-border services rendered by the domestic company AA. In fact, those services are subject to current taxation in the same way as the services rendered by company B (alternative 2) and, in principle, those of company C (alternative 3). However, since the latter company provides the services to a recipient in the same state which utilises the respective services for an income-producing activity in state C, an exemption from the current taxation of income produced in that state might be granted. Such an exemption would, of course, also be granted to company B if the requirements are fulfilled. At first glance,

[75] It is assumed that an additional entity in state C (company CC) is needed and that the activities cannot be combined within one legal entity.

the regime applied by state A leads to an equally restrictive treatment of domestic and foreign (tainted) investments. It is therefore, in principle, not a one-sided restrictive treatment of cross-border investments in favour of domestic investments. It may rather be seen as the implementation of additional requirements for the activities “behind the border” which can even lead to a more favourable situation compared to the investment in state A. In this particular case, the investment in state B may be “as unattractive as the domestic investment in state A” for the purposes of rendering the services to company CC. However, the criterion applied for an exemption in state B is the same as for state C. In other words, the restrictive regime of state A applies to all tainted activities, no matter whether the activities are carried on in state A, B or C, but it opens the possibility of applying for an exemption if the services are provided within the state where the income is actually produced (with the important exception for services provided within state A). Theoretically, the anti-avoidance system of state A applies consistently to all foreign investments and the exemption is granted to all foreign activities under the same conditions.

Even though it is apparent from the case law of the ECJ that national legislation does not have to stand a direct comparison of an investment in two different Member States (horizontal comparison) in order to comply with the basic freedoms, it remains questionable whether the different treatment is in line with the concept and the idea of an internal market.[76] This is not a question of an infringement of one or more basic freedoms, but a more general question. Looking at the situation here, especially the situation of the aforementioned alternative 2 compared to alternative 3, it is obvious that the investment in Member State B is less attractive compared to the investment in Member State C. However, the different treatment of an investment in Member State B is not caused by objective criteria which always - and under all circumstances - leads to an unfavourable treatment of an investment in Member State B, but it is just due to the fact that the recipient of the services is, in this particular case, not established in the same Member State as the service provider. For example, if Member State C is a huge market and the Member States A and B are rather small markets, it may be the case that a large number of potential customers in Member State C require different types of services which also attract investors of Member States A and B. If the investor in Member State A has the choice to invest in Member State B or in Member State C - in order to provide the services to recipients in Member State C - the exemption provision outlined above can clearly support the investment in Member State C to the detriment of Member State B. In other words, the national legislation of Member State A would make, in this particular case, the investment in Member State B (and theoretically even the investment in Member State A) less attractive compared to the investment in Member State C. Moreover, it may be more attractive for company B to provide services within Member State B since it would not result in an immediate income allocation to the parent company A. For company CC, this could have the effect that services of companies established in Member State B are not available to the same extent or the services are available under different conditions. In any event, it is possible that company CC, as the recipient of the services, can be negatively affected by the legislation of Member State A.

In addition, it is questionable whether such a “self-restriction” in favour of the country of investment can be more than just a theoretical consideration. It can be assumed

[76] See section 8.2.4.2. with regard to the necessity of a vertical / horizontal comparison.

that Member States are, in practice, rather reluctant to grant an exemption provision in the aforementioned manner. Moreover, it would have to be verified whether such an approach can eventually raise constitutional questions in Member State A. It should not be overlooked that - from an equity perspective and an economic perspective - the exemption from current taxation in the state where the income is produced should be equally relevant for the investor in Member State A (i.e. the individual shareholder in Member State A who invests in a domestic company which carries on tainted activities only in Member State A). Overall, based on the above conclusions and the case law of the ECJ, it is necessary to follow a strict and consistent anti-avoidance approach which should have the consequence that the basic interest component is, in general, to be taxed in all of the alternative scenarios.

9.4.10.7. Other Exemption Provisions

The exemption rules provided for in the context of CFC regimes cannot simply be transferred to the alternative anti-avoidance legislation. For example, a “motive test” does not really fit into the proposed system. The reason is that the intention of the taxpayer for the provision of certain services is irrelevant for the decision whether it should be currently taxed or not. In other words, the mere fact that capital services are rendered to another party is no reason whatsoever to make a distinction which is based on the motive of the taxpayer. Moreover, it should be clear that an exemption provision cannot be connected to the tax rate of a particular state and should not be based on the existence or non-existence of double tax conventions. The alternative legislation requires a consistent application to foreign and domestic tainted investments without “picking out” certain states.

The question may be raised whether an “acceptable distribution policy” might be a logical and acceptable reason for an exemption provision. Clearly, the full distribution of the profit generated by the company which carries on the tainted activities on a regular basis would make an anti-deferral provision obsolete - because there is no deferral. However, the decisive factor should not be the regular and full (or almost full) distribution of the profits, but rather the income which is related to the basic interest component. The reason is that the company which operates in another state should have the possibility of re-investing its profits and should not be obliged to distribute the income which is related to the activity component and the risk component. This, of course, is especially important if a substantial tax rate difference exists between the state in which the tainted activity is carried on and the state of residence of the shareholder. Furthermore, the implementation of such an exemption provision might be difficult and would make the application of the regime rather more complicated. This is, in particular, due to the fact that the proposed system does not only focus on the direct shareholder but also on the indirect shareholder. The system should therefore, in my opinion, not necessarily provide an exemption which is directly connected to the distribution policy of the respective entity.

In any event, the exemption provisions outlined above can theoretically be differentiated further - depending on the situation and the approach followed by the respective Member State. For example, the percentages for property ratio, income ratio et cetera can be higher or lower and can, therefore, increase or decrease the number of cases which are subject to CSC taxation. It is also possible to make a further differentiation with respect to the exemption based on the classification of the service recipients. For example, the proposed exemption may be restricted to banks, insurance companies, leasing companies and comparable institutions but may exclude certain asset management activities from the exemption provision. This would lead to a further “fine-tuning” of tainted activities with a higher or lower risk of tax avoidance.

9.4.11. The Litmus Test: CSC Legislation, Internal Market and EU Law

Apart from the fact that the proposed alternative anti-avoidance legislation should be in line with the economic and equity principles, it is of utmost importance that the legislation complies with the concept of an internal market and the primary and secondary EU law - especially the basic freedoms stipulated in the TFEU. The requirements and the critical aspects have been examined in some detail in previous chapters, and this was taken into account for the drafting of the proposed CSC legislation. It is absolutely clear that the CSC concept must, first of all, fulfil its purpose of an efficient anti-avoidance system which is fully in line with EU law. If this is not the case, the legislation cannot be applied. However, apart from these “hard factors” of primary and secondary EU law it also seems to be important that the proposed CSC legislation complies with the idea and the concept of an internal market.

9.4.11.1. The Compliance with the Concept of an Internal Market

The current taxation of the basic interest component in case of tainted activities is, in my opinion and as already stated earlier, not only completely in line with the idea and the concept of an internal market, but it may even be considered to be necessary to avoid inefficient structures and inefficient capital allocations. This, of course, is particularly important in those cases in which the basic interest income is produced in another state, i.e. not in the state where the service company carries on its activities. However, I have to confess that the current taxation of the basic interest component which is produced in the state of the service company, although not by the same entity, is only the second-best solution. Nevertheless, the fact that any other approach would be almost impossible to implement and, in my opinion, would lead to situations which are not in line with the concept of an internal market, makes it necessary to partially deviate from the theoretical requirements. However, the strict limitation of the current taxation of income to the basic interest component reduces the problem considerably. What prevails, in my opinion, is the positive effect of such legislation for an internal market as a whole. Thus, the proposed CSC legislation is an anti-avoidance system which supports the concept and the further development of the European Union.

9.4.11.2. The Compliance with Primary European Union Law

It is obvious that the current allocation of income is a legislative measure which can have a restrictive effect on investments and can therefore influence the decision of the place of investment. This is not only true for income allocations under a CFC regime but can be also true for (limited) income allocations under a CSC regime. However, the fact that the current allocation of income is the core element of the proposed anti-avoidance legislation, it is necessary that the system is structured in a non-discriminative manner. This ensures that the investment in companies which carry on certain types of tainted activities is always treated in the same manner, no matter in which country the activity is carried on. In this case, the current allocation of income will not be the decisive element for an investment decision. The proposed CSC legislation is, therefore, based on such a non-discriminatory approach by allocating to the resident shareholder the basic interest component which is related to tainted activities carried on through resident and non-resident entities. This is not necessarily the simplest approach - because it increases the overall administrative burden for taxpayers and tax authorities - but it is the approach which is required by EU law. Even though I think there are important arguments in favour of a basic interest taxation which makes a differentiation between domestic and foreign investments, as already outlined earlier, it is obvious from the case law of the ECJ that those arguments cannot justify the restriction on the relevant basic freedoms. Therefore, the non-discriminatory system of income allocation focuses on certain capital services and must be supported by non-discriminatory exemption provisions in order to limit the application of the CSC system to investments which entail an increased risk of tax avoidance. The key factors of the CSC legislation to ensure the compliance with the basic freedoms, the concept and the idea of an internal market and, at the same time, the effectiveness of the anti-avoidance system are

- the limitation to tainted activities which entail - from the perspective of the state which applies such legislation - an increased risk of tax avoidance;

- the application of the system in a non-discriminatory manner to tainted activities carried on through resident and non-resident entities;

- the strict limitation of the current allocation of income to the basic interest component;

- the granting of non-discriminatory exemption provisions;

It must be clear that the non-discriminatory approach requires more than just the application to income derived by resident and non-resident entities. It is important that the whole concept does not provide for differences in the treatment of the basic interest taxation which is due to the tax credit system, tax losses, multiple-tier structures, et cetera. In other words, the legislation must provide for an equal treatment under all circumstances. For this reason, the CSC legislation provides for a current taxation of the basic interest component which is largely unconnected to the regular income taxation of the shareholder and which ensures, therefore, an equal treatment of income allocated from foreign tainted activities and domestic tainted activities.

a.) Limitation to tainted activities

The fact that the proposed CSC legislation solely focuses on certain types of capital service activities (tainted activities) should not be a problem from the perspective of primary EU law. In my opinion, there is no obligation which can be derived from EU law which requires the Member States to treat all types of activities in the same manner for income tax purposes. In essence, what the proposed CSC legislation does is to provide for a current taxation of the basic interest component derived from tainted activities under certain circumstances. The legislation neither leads to a systematic double taxation of income nor creates any other comparable disadvantage. Moreover, the subsequent profit distribution finally combines the (special) system of CSC taxation with the regular income tax system. Thus, the CSC legislation leads to a temporary difference which is solely caused by the effect of an immediate income allocation (and taxation). Again, the fact that such a system is only applied to situations which entail - from the perspective of the Member States which apply such legislation - an increased risk of tax avoidance, is in line with the basic freedoms of the TFEU as long as the system is applied in a non-discriminatory manner to foreign and domestic tainted activities.

b.) The “tax rate effect” of the credit method

The proposed CSC legislation provides for an allocation of the basic interest component to the ultimate domestic shareholder(s). These can be individuals as well as legal entities - including non-residents which hold the shares in the CSC through a permanent establishment in the country which applies the CSC legislation. In case of individuals, a (preliminary) flat income tax rate will be applied which can be derived - depending on the system of the respective Member State - from the domestic corporate income tax rate. It is absolutely clear that the tax burden of the domestic shareholder, in the first step, strongly depends on the taxes imposed on the basic interest income on the lower (group) level. For example, if the tainted income is derived by a resident legal entity, it may be the case that there is no additional income tax burden imposed on the resident individual shareholder since the corporate income tax rate and the flat income tax on the current income attribution is in both cases - for example - 30 percent. Here, the tax credit is exactly as high as the corporate income tax levied on the basic interest component. The same will be true if the tainted activities are carried on in a state where the corporate income tax is higher than in the state of the resident shareholder. The ordinary income tax credit system will provide for a tax credit up to the amount levied in the other state(s). Thus, if the corporate income tax rate is 35 percent, there will be - in a typical situation without tax losses et cetera - no additional income tax payments in the residence state of the shareholder. In contrast thereto, if the tax rate in the state where the tainted activities are carried on is only 10 percent, this will have the effect that the shareholder can only credit the 10 percent against the 30 percent domestic income tax - with the consequence of an additional tax of 20 percent. Of course, the strict application to domestic *and* foreign investments as well as the consistent application of an ordinary tax credit system may lead to the outcome that in a merely domestic context the additional income tax will be zero - in a typical situation - whereas it will most often lead to additional income tax payments on the attributed income if it is related to tainted activities in a country with a lower income tax rate. The question is whether this can still be a critical element which has a restrictive effect on tainted investments in a particular country with an income tax rate which is lower than the domestic (flat) income tax rate - even though the system is, in principle, applied in a non-discriminatory manner.

In order to answer this question it is very important to keep in mind that the lower (or different) taxation - in contrast to the situation in the *Cadbury Schweppes* case or the *Eurowings* case - is not the decisive element for the application of the CSC taxation. Instead, it is only the fact that the entity carries on tainted activities. This - and nothing else - is the triggering factor for the current income allocation which imposes additional administrative obligations for the shareholder - no matter whether it is a resident or non-resident entity which carries on the activities - and which results in an immediate taxation for the domestic shareholder. Theoretically, there may be an additional income tax payment in case of foreign and domestic investments -

irrespective of whether the foreign income tax rate is higher or lower (e.g. in case of tax losses). However, the fact that it is most often the investment in low-tax countries which triggers an additional income tax payment is only due to the tax credit system: it limits the crediting of income taxes to the taxes actually imposed on the respective income. Of course, such a credit system can make the investment in a low-tax country less attractive compared to a system which provides for a complete exemption from domestic taxation. But this is not the point. The decisive question is whether the domestic legislation provides for a different treatment of two comparable situations, i.e. taxation of the income in one case but exemption of the income in another. Again, the CSC legislation clearly follows a non-discriminatory approach and taxes all tainted activities - under the same circumstances - according to an identical system. Moreover, it should not be overlooked in this respect that the CSC legislation is strictly limited to the current taxation of the basic interest component. That means, all other income elements can take advantage of a lower taxation in the respective country. Thus, if the exercising of functions in the low-tax country is more attractive than in the state of residence of the shareholder, this will not be influenced by the proposed CSC legislation since the latter provides for an exemption of the activity component and the risk component. This is, in my opinion, a differentiation of some relevance: one should not forget that any foreign investment, even if it is an investment in another Member State, is still accompanied by additional risks and uncertainties (which are, *inter alia*, related to the fact that the investment is in another country), additional administrative obligations, additional expenses, et cetera. If, in such a situation, the investor cannot take advantage of the lower tax rate with respect to the income related to the activity component and the risk component, it may clearly influence his decision whether he should invest abroad or whether he should invest in the state of residence. For this reason, a legislation which focuses on the current taxation of the total amount of income derived by resident and non-resident entities follows, at least at first glance, a non-discriminatory approach. But at the end the legislation will influence the investment decision more than it should within an internal market environment. Moreover, in contrast to the general application of the credit system, e.g. in case of permanent establishments, the non-discriminative application of CFC regimes still makes a differentiation between different types of income. The combination of defining certain types of tainted income - be it under a transactional approach CFC regime or under an entity approach CFC regime - *and* the complete attribution of income is a critical mixture. It can have the effect that it affects some Member States more than others, namely those which attract - based on the insufficient infrastructure - rather low-function capital services instead of sophisticated service activities and production activities. Of course, this is not the main issue here, but it cannot be ignored in an internal market. Hence, the proposed CSC legislation with its strict limitation to the basic interest income has far less influence on any investment decision than the regular taxation of foreign permanent establishments of "credit countries" and a (theoretical) CFC legislation which is extended in a non-discriminatory manner to foreign and domestic tainted income. In my opinion, the consistent and non-discriminatory application of the credit method - in the context of the proposed CSC legislation - is not, therefore, contrary to primary EU law.

9.4.11.3. The Compliance with Secondary European Union Law

Based on the conclusions drawn in chapter 8, it seems that secondary EU law does not play a role which is comparable to the role of primary EU law for the application of CFC and CSC rules. However, if the (revised) Parent-Subsidiary Directive is applicable to the current attribution of income, and it seems that this is the case, the system is required to provide for the elimination of double taxation by applying the exemption method or the credit method. It was already stated above that the proposed CSC legislation ensures a consistent elimination of double taxation - even in critical cases (e.g. existing tax losses) - by separating the concept of current taxation of income from the “regular” tax system. Thus, the proposed concept goes further than the typical tax credit system applied in the field of international taxation. In my opinion, the proposed system should, therefore, be fully in line with the requirements of the Parent-Subsidiary Directive.

9.4.12. CSC Legislation and the OECD Model Tax Convention

9.4.12.1. CSC Taxation and Non-Transparent Entities

In chapter 7 it was concluded that the OECD-MTC does not prevent the application of a system which is based on the current taxation of the basic interest component. In my opinion, the allocation of the latter component to the resident shareholder does not result in a juridical double taxation of income, because it refers to two different taxpayers (the CSC and the shareholder in the CSC). Thus, there is, in principle, no necessity to amend a tax treaty which is based on the OECD-MTC in order to apply such legislation. Moreover, one has to keep in mind that - in contrast to the typical CFC regimes which were outlined in chapter 6 - the CSC legislation provides for a horizontal and vertical separation of income and, therefore, taxes only a fraction of the income derived through the interposition of the CSC. In addition, a number of exemptions are provided under the proposed legislation. Overall, it is very unlikely - at least if more than one year is taken into account - that the income attributed under the CSC regime will be identical to the income derived by the CSC. Beside the strictly legal question, one can certainly argue that there is - from a political perspective - a clear difference between the application of a system which taxes the complete income of another entity (as may be the case under the typical CFC regimes, especially under the entity approach regimes) and the basic interest taxation. The latter system shows that the state which applies the CSC regime has no intention of taxing all or almost all of the income derived through the entity established in the other contracting state.

9.4.12.2. CSC Taxation and Permanent Establishments

The picture is a bit different if the activity is carried out through a permanent establishment (PE) in another state.[77] As already outlined earlier in this chapter, the consequences depend very much on the fact whether the tax treaty determines the application of the credit method or the exemption method for the avoidance of double taxation of income generated through a PE. If the tax treaty (i) provides for the application of the credit method and (ii) the state of the headquarter company taxes the income of the PE according to the credit method, there is basically no room for a basic interest taxation of the tainted activity. The reason is that all income components (including the basic interest component) are already taxed in the state of the headquarter company. Of course, this is a non-optimal scenario, but a calculation of the basic interest component which is separated from the allocable income (and taxed separately) would not result in any advantage - but rather a lot of confusion

[77] This, of course, encompasses also transparent entities which are usually seen as permanent establishments in the tax treaty context.

and unnecessary administrative burdens. In this case, the anti-avoidance (anti-deferral) target has already been achieved.

However, if the tax treaty provides the possibility for the application of the credit method in order to avoid the double taxation of income generated through a PE, but the state of the headquarter company follows the exemption method, there is no obstacle for the application of the CSC taxation. Here, it is not only justified but even necessary to tax the basic interest component - just like in case of a non-transparent legal entity. The latter approach is therefore by no means restricted by the relevant tax treaty.

The situation is different, however, if the tax treaty explicitly provides for the application of the exemption method in order to avoid the double taxation of PE income. In this case, the CSC taxation would not be in line with the tax treaty - because the part of the income which is related to the basic interest component is taxed according to the credit method. In essence, the CSC taxation applied to PE income would result in a treaty-override. Of course, the question is whether the treaty-override would have any direct and immediate consequences. From an EU law perspective, the fact that the CSC taxation results in a treaty-override does not affect the outcome with respect to an examination of an infringement of the basic freedoms under the TFEU. This is particularly clear from the *Columbus Container* decision - a case which deals with the taxation of PE income and which is very similar to the application of CSC rules. In this case, the ECJ concluded that the Court may not examine the relationship between a national measure and the provisions of a tax treaty since that question does not fall within the scope of EU law.[78] However, even if we leave aside the fact that there will be no consequences from an EU law perspective, it is obvious that a state which entered into tax treaty with another state should not contravene the provisions of the tax treaty through the application of national measures. So, in order to apply the proposed CSC rules it is advisable - in this particular situation in which the PE income shall otherwise be exempt from taxation according to the treaty provisions - to refer to the application of such legislation. This seems to be the only possibility of avoiding a treaty-override.

In summary, it is only the latter situation in which the tax treaty explicitly provides for the application of the exemption method which requires the concrete reference to the CSC taxation. However, it is equally clear that the application of the CSC taxation is less “aggressive” - also in the light of the relationship with the other contracting state - than the typical CFC legislation which usually focuses on all (vertical) income components. Moreover, there are clear economic and equity reasons behind the current taxation according to the CSC legislation. Therefore, I consider it less likely that the application of the CSC legislation results in serious conflicts between the tax treaty partners. This is all the more the case if one takes into account that the current taxation is also strictly limited in case the income is generated through the interposition of non-transparent entities, i.e. if basically no explicit reference in the tax treaty is required. This should not be understood as a suggestion or a justification for a tax treaty-override, but it shows that the overall impact of such an override is very limited. However, one may even see it from a different angle: the fact that the CSC regime solely focuses on the basic interest component might open the door for an argument - supported by economic and equity reasons - to amend the respective

[78] See in this respect case C-298/05 (*Columbus Container*), paragraphs 46, 47 and case C-141/99 (*Amid*), paragraph 18. This was later on confirmed in case C-128/08 (*Damseaux*), paragraph 22.

double tax convention and to explicitly include the possibility of applying the respective regime.

9.4.13. CSC Legislation vs. CFC Legislation

Theoretically, there can be different reactions of the Member States on the outcome of the *Cadbury Schweppes* case. It may lead to an increased political pressure for the introduction of an EU wide minimum income tax rate or for comparable measures of harmonisation. It may also lead to the political request for a uniform approach related to low-tax countries outside of the EU. The final outcome from a political perspective, however, is difficult to estimate and it is quite likely that a common European approach can only be achieved in the long run. The immediate unilateral reactions of the Member States which can be expected are, in my opinion, either the adjustment of CFC rules in a way which complies with the requirements derived from the *Cadbury Schweppes* case - i.e. the implementation of a possibility for the taxpayer of proving that the structure is not merely artificial - or the extension of the existing CFC rules to comparable domestic investments and investments in other (high-tax) countries. As already outlined earlier, the first-mentioned reaction has the effect of changing the scope of the legislation completely. It is therefore rather unlikely, in my opinion, that all of the Member States which apply CFC regimes will follow such an approach. However, it can be expected, in my opinion, that Member States extend (or try to extend) their CFC regimes in a non-discriminatory manner to domestic investments and investments in other (high-tax) countries. It is worth noting in this context that the Council of the European Union published a Resolution on the coordination of CFC and thin capitalisation rules within the EU.[79] With regard to CFC rules, the Resolution recommends that Member States adopt some guiding principles for the application of CFC rules.[80] However, the Resolution merely presents a list of indicators for the identification of artificial arrangements. Thus, it can be a helpful element to align the approach of the Member States with respect to the separation of artificial structures from non-artificial structures, but not really more than that. For this reason, it is important to understand and to highlight the main differences between CFC legislation - which is extended in the manner outlined above - and the proposed system of CSC legislation.

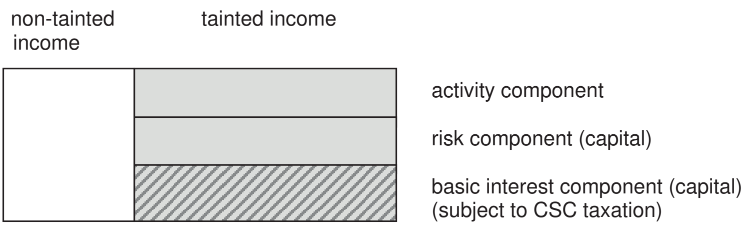
9.4.13.1. CSC Legislation vs. Transactional Approach Income Allocation

The non-discriminatory application of a CFC regime which is based on the transactional approach means, essentially, that certain types of passive income and base company income are allocable to the domestic shareholder - irrespective of whether they are related to income derived by a resident or non-resident entity. I doubt that the transactional countries are able to transfer the existing discriminatory system to a non-discriminatory system without making substantial amendments, in particular with respect to the definition of passive income, base company income and the granting of additional exemptions. For example, the rendering of inter-company services is an important issue within national and multinational groups. If the mere fact that a company provides (any type of) services to a resident or non-resident related company leads to the application of the (amended) CFC rules, the

[79] Council Resolution of 8 June 2010 on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union. The Council Resolution was published in the Official Journal of the European Union on 16 June 2010 (2010/C 156/01).
[80] See part A of the Council Resolution and section 8.7. of this study.

administrative burden would increase dramatically. However, even if the system is amended properly in order to avoid that each and every transaction is subject to current taxation (e.g. by providing additional exemptions) it would still be against the idea and the concept of an internal market. The reason is that all of the passive and base company income which is now allocated in a non-discriminatory manner contains elements which should by no means be subject to immediate taxation in the hands of the shareholder. The fact that the application of the CFC rules is not limited anymore to low-taxed countries but also encompasses "medium-" and high-tax countries increases the problem. Overall, the non-discriminatory income allocation based on a transactional CFC system leads to a disadvantageous treatment of the activity component and the risk component included in certain types of passive and base company income. The question whether the determination of the allocable income under the CSC regime is simpler than the determination of the tainted income under a non-discriminatory (amended) transactional CFC regime cannot be answered in general and for all situations. Both systems require detailed information related to the company which carries on the tainted activities and both systems require some sort of detailed calculation - either in order to determine the tax base for the basic interest component or to determine the tainted income itself. However, the CSC legislation focuses on the separation of tainted and non-tainted property and the simplified allocation of liabilities to the respective property whereas the CFC legislation requires the separation of income and the detailed allocation of expenses to the respective income. In my opinion, the latter approach goes further and can become more complicated since it theoretically requires the correct allocation of all types of expenses to the tainted and non-tainted income.

Figure 34:



Explanations:

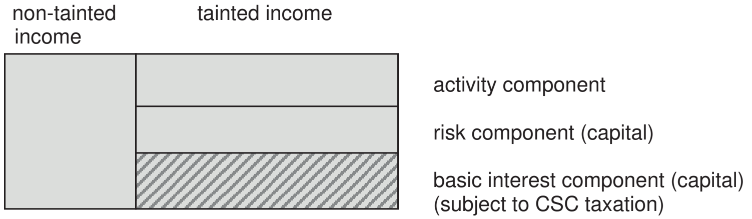
(1) "Income block" divided into non-tainted and tainted income (horizontal) and into the three different income components which are of importance for capital intensive activities (vertical). The vertical separation of the non-tainted income is not required, because no element is included which should be subject to the current taxation of income in the state of the shareholder.
(2) Assumption: tainted activities under the CFC regimes = tainted activities under the CSC regime.
(3) White area: not subject to income allocation.
(4) Grey area: subject to income allocation under a transactional approach CFC taxation.
(5) Grey-striped area: subject to income allocation under a transactional approach CFC taxation and under the CSC regime.
(6) The size of the three income components is just an assumption.

The figure shows that the horizontal separation of income leads to a complete allocation of all income components included in the tainted activities under the transactional based CFC taxation. In contrast thereto, the vertical separation under the CSC taxation only allocates the basic interest component (grey-striped area). The assumption that the definition of passive and base company activities under the CFC taxation is identical to the definition of tainted activities under the CSC taxation is, of course, not always true. However, an overlapping is very likely.

9.4.13.2. CSC Legislation vs. Entity Approach Income Allocation

What makes the non-discriminatory entity approach different from the non-discriminatory transactional approach is the fact that either all of the income generated through the resident or non-resident entity is allocable to the shareholder or nothing is allocable to the shareholder. Thus, the decisive factor is the extent of certain activities within the total activities carried on by the entity. If the tainted activities encompass a substantial part of the activities, this will lead to the current taxation of all income derived by the entity. In other words, if the tainted activities are dominating, this can "infect" the whole income generated by the respective entity. In the latter case, the effect is worse than in case of a transactional system since it taxes income on a current basis which is otherwise not subject to current taxation at all. Therefore, if the non-discriminatory transactional approach is not in line with the idea and the concept of an internal market, this will be all the more true for the non-discriminatory entity approach. Of course, an all-or-nothing approach has the advantage of avoiding the complicated separation of income and the allocation of expenses to the tainted and non-tainted activities. However, simplification can only be the decisive element if it is not - at the same time - contrary to the basic principles of an internal market. The increased number of exemptions in case of CSC legislation has a different effect compared to the all-or-nothing concept of an entity approach CFC legislation. The exemption rules lead to the outcome that either nothing will be taxed on a current basis or the basic interest component will be taxed on a current basis. In contrast thereto, the entity approach CFC legislation has the effect that either nothing will be taxed on a current basis or everything will be taxed on a current basis. Again, this is a non-acceptable approach within an internal market - even if it is applied without discrimination.

Figure 35:



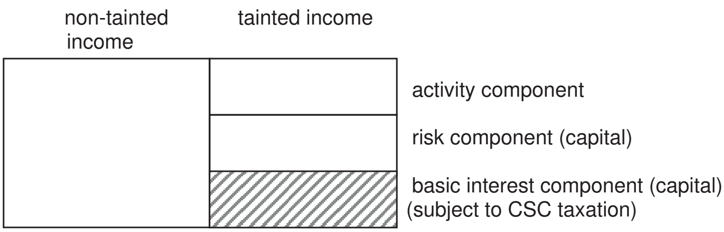
Explanations:

(1) "Income block" divided into non-tainted and tainted income (horizontal) and into the three different income components which are of importance for capital intensive activities (vertical). The vertical separation of the non-tainted income is not required, because no element is included which should be subject to the current taxation of income in the state of the shareholder.
(2) Assumption: tainted activities under the CFC regimes = tainted activities under the CSC regime. The entity derives mainly tainted income.
(3) Grey area: subject to income allocation under an entity approach CFC taxation

(4) Grey-striped area: subject to income allocation under an entity approach CFC taxation and under the CSC regime.
(5) The size of the three income components is just an assumption.

In this case, the entity approach CFC legislation allocates the total amount of income derived by the service company to the resident shareholder. Thus, the general differentiation between active activities and passive activities does not play a role anymore as soon as the latter activities prevail within the total activities carried on by the entity.

Figure 36:

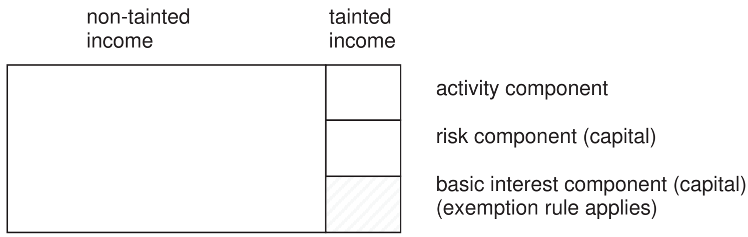


Explanations:

(1) "Income block" divided into non-tainted and tainted income (horizontal) and into the three different income components which are of importance for capital intensive activities (vertical).
(2) Assumption: tainted activities under the CFC regimes = tainted activities under the CSC regime. The entity derives mainly non-tainted income.
(3) White area: not subject to income allocation.
(4) Striped area: subject to income allocation under the CSC regime only.
(5) The size of the three income components is just an assumption.

In contrast thereto, the income derived by the service company is normally excluded from CFC taxation if the tainted (or passive) activity is not the "main" activity. The treatment under the CSC system strongly depends on the exemption provisions which have been proposed. If the property-ratio and income-ratio are stipulated, for example, at 75 percent, it may be the case that the income would not be subject to CFC taxation, but the basic interest component would still be subject to CSC taxation. However, if the income of the entity is almost completely derived from non-tainted activities, it may also be the case that neither the CFC regime nor the CSC regime results in an income attribution. The differences here are first of all related to the question how to set an appropriate threshold under both concepts, CFC and CSC taxation. However, the CSC system provides - in addition to income and recipient related exemptions and a general threshold - an exemption provision which is directly connected to the capital invested in tainted property (because the latter is eventually the calculation basis for the attributable basic interest component). It is therefore obvious that the property ratio is an important element for the determination of an exemption from CSC taxation. A property ratio, though, does not (and cannot) play a similar role under a typical CFC regime. The reason is that the income attribution under a CFC regime is disconnected from the underlying (tainted) property and a change in this regard would require a conceptual change in the CFC systems.

Figure 37:



Explanations:

(1) “Income block” divided into non-tainted and tainted income (horizontal) and into the three different income components which are of importance for capital intensive activities (vertical).
(2) Assumption: tainted activities under the CFC regimes = tainted activities under the CSC regime. The entity derives almost all income from non-tainted activities.
(3) White area: not subject to income allocation.
(4) The size of the three income components is just an assumption.

In this situation, the non-tainted activity encompasses almost all of the activities of the CSC. For this reason, the income is neither subject to current taxation under an entity approach based CFC regime nor subject to CSC taxation (if the proposed exemption provisions are taken into account).

9.4.13.3. The Abolition of the Low-Taxation Requirement

The abolition of the link to a lower income tax rate, as one of the requirements for the application of CFC rules, is unavoidable for a non-discriminatory approach which applies equally to certain types of income derived by resident and non-resident entities. This was already mentioned above. The consequence is clear: it increases, in general, the amount of allocable income since it not only encompasses the activities of low-taxed entities but also the activities of “medium-“ and high-taxed entities.[81] What is more important, however, is the fact that an amended CFC regime which also applies to resident entities increases, at the same time, the income allocation which is related to the activity and the risk component. That means there will be an additional allocation of income if an identity exists between the place where the entity carries on its activities and the place where the income is produced. Of course, this goes into the wrong direction if one follows the concept of capital import neutrality.

9.4.13.4. The Income Allocation and Tax Credit System

It has been shown that the inclusion of the allocated income in the tax base of the shareholder under the transactional and entity approach CFC regimes can create substantial difficulties and is - at least as far as it relates to the asymmetrical treatment of negative income in some countries - not in line with the basic freedoms. However, even the extension of those regimes in a non-discriminatory manner does not necessarily solve the problem. For example, if the domestic legislation provides

[81] At least, this is true as long as the number of exemptions is not increased in the context of a non-discriminatory system.

for a system of fiscal unity (fiscal consolidation) only for domestic legal entities, like in the *Marks & Spencer* case, it may also influence the CFC regime. If the resident entity can be part of such a fiscal unity system, the negative CFC income could be offset with positive income of the parent company. In contrast thereto, there is no possibility of a fiscal unity in case of a non-resident entity, with the effect that the positive income would be included (similar to a fiscal unity) but the negative income would be excluded. Here, the issue is not the existence or non-existence of a cross-border fiscal unity system as such, but the application of a CFC regime in combination with the system of fiscal unity. This is an undesirable result, because it finally means that national legislation like CFC rules can be structured in a non-discriminatory manner but additional (different) legislation eliminates, e.g. by electing a domestic fiscal unity system, (part of) the restrictive effects only for resident entities. There is no indication from the existing ECJ case law that the effects resulting from the aforementioned combination as such lead to an unjustifiable infringement of the relevant basic freedoms. However, it finally remains a situation which is, in my view, contrary to the concept and the idea of an internal market.

Hence, what the Member State which applies the CFC regime should do - if the asymmetrical treatment of income is not to be changed - is either to extend the fiscal unity system to non-resident CFCs or to exclude the resident CFCs from such a system. Both alternatives require a substantial change of the transactional approach CFC regimes as well as of the entity approach CFC regimes. This is not the case with regard to the proposed CSC concept, because the latter does not provide for an asymmetrical income allocation. Moreover, it is apparent from the case law of the ECJ that there is, in principle, no necessity to extend the fiscal unity system to non-resident entities - which leads to the consequence that there is no pressure on Member States to generally extend the fiscal unity system.[82]

In my opinion, it is therefore consistent to separate the system of current income taxation from the “regular” system. It seems that this provides the possibility of ensuring that the currently attributed income is by no means treated worse than income which is not currently attributed but distributed at a later point in time. This is an important aspect if one takes the view that the current attribution of income should just have the effect of an immediate taxation but not an additional “penalty effect.” This exactly is the idea of the basic interest taxation and it can be achieved by the proposed concept of CSC taxation but not, in my opinion, by CFC regimes. As already outlined earlier, the mixing of current income taxation with the regular taxation may lead to a number of difficulties which eventually result in a double taxation of income and in the aforementioned “penalty effect.” The latter effect is, *inter alia*, caused by the insufficient tax credit system, the exclusion of negative income, and the insufficient consideration (on a higher tier) of CFC regimes and similar regimes applied on a lower group level. Here, I do not want to repeat the aspects which have been outlined in this chapter and in previous chapters but it seems to be out of the question that CFC legislation remains - even if it is applied in a non-discriminatory manner - an anti-avoidance legislation which can be extremely burdensome for the taxpayer because of the “side-effects” and not merely because of the current taxation of income. If such a non-optimal system for low-tax countries is transferred to medium- and high-tax countries, it is more than likely that it may lead to additional distortions of the investment decisions. Of course, one might argue that the

[82] See with regard to the application of a fiscal unity system to non-resident entities also case C-231/05 (*Oy AA*) and case C-337/08 (*X Holding*). See section 4.2.10.3.6. for further details.

CFC regimes could be adapted step by step to come closer to the proposed CSC concept. Clearly, the adjustment of some elements would be an improvement, e.g. the abolition of an asymmetrical treatment of income allocation and the insufficient credit system. However, this would by no means result in an alignment of the two systems since they have very basic and methodological differences in the conceptual framework. The most important differences are the horizontal *and* vertical separation of income elements and the focus on the tainted assets for the determination of the attributable income under the CSC concept (to a large extent unconnected to the actual determination of the CFC income). The latter is something which is not existent under the typical CFC regimes and would require such a massive change of the regimes that it seems to be simpler to draft a completely new concept. In other words, a substantial amendment of the CFC regimes is, in my opinion, not an alternative to the CSC concept.

9.4.13.5. The Taxpayers Subject to Current Taxation of Income

If an anti-avoidance legislation is restricted to the taxation of the basic interest component, it is clear that it must be structured as efficiently as possible. This not only requires, as outlined above, that the income allocation is treated separately from the regular income tax system and that the tax credit system provides for a complete and consistent elimination of double taxation, but it also requires, in my opinion, that the income is allocated to the ultimate resident shareholders and not only to the lowest domestic group level. For this reason, the CSC legislation is structured in a way that the income is allocated up to the highest domestic group level - if possible to the ultimate individual domestic shareholder. The system of CSC legislation does not allow resident entities with tax losses (or tax loss carry forwards) to be interposed for the purpose of offsetting positive attributable income with negative income of the respective entity. Thus, as long as one of the resident direct and indirect shareholders is subject to regular income taxation - since no tax losses are available - it will result in the taxation of the attributable CSC income, even if one or more of the lower-tier resident entities between the respective shareholder and the CSC are in a loss position. In my opinion, this is a consistent and acceptable result which clearly leads to a strengthening of the anti-avoidance legislation. The latter effect can typically not be achieved through the existing CFC rules. Possible distortions can be avoided by applying a (preliminary) flat income tax rate on the attributable income which can be derived from the domestic corporate income tax rate. The subsequent mechanism of dividend payment or the disposal of shares finally results in a complete equalisation of currently attributed income and income which was not currently attributed but distributed later on (or the shares in the company were sold). That means the current income attribution under the CSC system will not result in a different (final) tax burden compared to the regular system.

9.4.13.6. Once Again: Effectiveness and Anti-Avoidance Legislation

It is obvious that Member States which apply CFC regimes might be tempted to extend such legislation to resident and non-resident entities without focusing on the income tax rate and by retaining the transactional or entity approach CFC system. The reason is clear: the more income is attributed to the shareholder, the less likely the relocation of activities to low-tax countries is. The fact that the system is applied in a non-discriminatory manner could give the Member States the impression that - although accompanied by higher administrative burden - the system is in line with EU law and the basic freedoms. As already mentioned above, this is not necessarily the case. Moreover, the conclusion "the more income is allocated, the higher the anti-avoidance effect" is contrary to the idea and the concept of an internal market. In contrast to the existing CFC regimes, the CSC taxation only focuses on the basic interest component of capital which is, in my opinion, the decisive factor for the relocation of income to other countries based on tax reasons. In addition, the system provides for exemptions from current taxation if the risk of tax avoidance is reduced. Even though tax reasons may theoretically play a role in case of the other income components, too, there are substantial economic and equity arguments for taxing these components in the host state. Hence, in an internal market the anti-avoidance legislation - which, in this case, has the effect of making a foreign investment in a low-tax country less attractive - should clearly be restricted to the income component and the circumstances which contain the highest (theoretical) risk of tax avoidance. The "full insurance mentality" of taxing the total amount of income of a non-resident entity in the hands of the shareholder on a current basis - be it the tainted income under a transactional approach CFC system or the total income under an entity approach CFC system - is not compatible with the philosophy of an internal market which has, as one of its main purposes, the aim of fostering the efficient allocation of capital. The proposed CSC system follows a "softer" concept which provides for a postponement of income tax payments and preliminary tax assessments under certain circumstances in order to ensure that the basic interest income is not subject to double taxation and to avoid the income taxation in situations in which the anti-avoidance aspect retreats into the background. The latter can be the case, for example, if the service company suffers permanent losses from its activities and does not pay any income tax. The constant calculation and attribution of the basic interest component to the resident shareholder should, in such a case, not lead to an immediate and irrevocable imposition of taxes. For this reason, a postponement of income tax payments in combination with a preliminary tax assessment ensures that the income tax in the hands of the resident shareholder must only be paid if income taxes are finally imposed on the attributed income on the level of the service company. If this is not the case, e.g. because the service company is to be liquidated before achieving a positive result, there is no reason from an anti-avoidance perspective to stick to an income taxation of the basic interest component in the residence state of the shareholder. Thus, such a softer concept does not mean that the approach is less effective. It solely means that the concept provides for additional relief within a strict and consistent system in case it would otherwise lead to a result which is not intended by the legislation. Again, one must keep in mind that the current taxation of income should by no means lead to a penalisation of certain investments and activities. The CFC taxation normally follows a different concept. The entity approach (all-or-nothing approach) mixes the active and passive income and allocates the total positive amount to the resident shareholder or exempts the total positive amount from income allocation. The transactional approach allocates the positive amount of passive income and often does not sufficiently consider a possible negative amount of active income derived by the service company. This, by itself, may have a distorting effect on investments in companies which carry on "mixed" activities. As already described above, the CFC regimes may be amended in order to come closer to the proposed CSC system, but the differences in the general conceptual framework are so substantial that, in my opinion, the systems cannot be aligned.[83] Thus, I am convinced that the basic interest taxation under a CSC system

[83] See section 9.4.13.4.

is, in contrast to CFC legislation, a feasible way of structuring a broad and effective anti-avoidance legislation without disturbing the efficient allocation of capital.

9.5. Conclusions

1.) The idea and the concept of an internal market do not, in general, preclude the limited application of the principle of capital export neutrality by taxing the basic interest component on a current basis.

2.) The residence-based taxation of the basic interest component in the state of an intermediate service company can have a "clustering effect" in favour of low-tax states. That means the positive tax effect can attract equity investments in low-tax states which will subsequently, on the level of the service company, be transformed into capital services, i.e. a switch from equity investments to all types of capital services in order to take advantage of the allocation of taxing rights under double tax conventions which follow the pattern of the OECD-MTC. The current taxation of the basic interest component - and therefore the limited application of the principle of capital export neutrality - can target the "clustering effect" and can therefore support an efficient allocation of capital among states.

3.) The taxation of the basic interest component requires a *vertical* and *horizontal* separation of income components instead of a merely *horizontal* separation of income. The latter approach of a horizontal separation is the typical approach under the existing CFC regimes.

4.) The vertical separation of income components seems to be particularly interesting from an anti-avoidance perspective, because not all of the income components are equally relevant in this respect. Therefore, I propose the separation into three different components:

- income related to an activity physically conducted in the state of the service company (*activity component*);

- income related to the compensation of risks which are related to the capital investment (*risk component*);

- income related to the basic interest component of capital (*basic interest component*).

5.) The *activity component* should be taxed strictly according to the principle of capital import neutrality and should therefore be subject to income taxation in the state where the income is actually produced. If this is the residence state of the service company, it should be subject to income taxation in the latter state only. The income should not be subject to any current taxation in the hands of the shareholder.

6.) The *risk component* should be taxed in the state where the income is produced, too. However, most often the risk component is allocated - based on the underlying double tax convention - to the residence state of the service company which provides the capital (e.g. in the form of loan agreements, licensing agreements, leasing agreements, and similar agreements). In this case, the risk component is a compensation for the increased risks involved in the capital investment and the taking over of these risks. Any current taxation of this income component would take away part of the risk coverage in the state of the service company. Theoretically, this makes it necessary that the negative income - caused by the realisation of these risks - is taken into account in the state of the shareholder in the same way in order to avoid any asymmetrical taxation of income. In my opinion, a consistent approach would require the immediate offsetting of this negative income with other - positive - income of the shareholder. The net result related to the risk component is therefore difficult to predict, at least over a longer period of time, and seems to me less attractive for any tax based relocation. From the perspective of the Member States which apply the anti-avoidance regime, the uncertainties related to this particular income component reduce the effect of a current income allocation and make the system less efficient. Overall, the conclusion in such a non-optimal scenario of a taxation of the risk component in the residence state of the service company is to exclude the latter component from any current taxation in the hands of the shareholder.

7.) The *basic interest component* is, in the same way as the other two components, an income element which should be taxed, in general, in the state where the income is produced. However, the allocation of the taxing rights to the residence state of the service company - based on double tax conventions - leads to the result that the basic interest component is neither taxed on the level of the company which produces the income nor in the state where the income is produced - at least in those cases where the state of residence of the service company is different from the state where the service recipient carries on the income-producing activity. In contrast to the activity component, the basic interest component can quite easily - and without any serious obstacles - be relocated from one state to another and to the place where the income taxation is most favourable. It is therefore by far the most flexible and mobile component. In contrast to the risk component, the basic interest component is not a compensation for the risk coverage and the taking over of risks. It is just the basic interest element which is related to the capital investment and can therefore be taxed, theoretically, and in the absence of the taxation in the state of income production, in the residence state of the service company as well as in the residence state of the shareholder. The current taxation of the basic interest component is therefore, in my opinion, an efficient tool in order to target the erosion of the tax base which is related to this particular income element.

8.) Such an anti-avoidance approach is supported by transfer pricing principles (e.g. the OECD transfer pricing guidelines), but it is obvious that the transfer pricing principles cannot be seen as a substitute for an anti-avoidance legislation which focuses on the current taxation of income.

9.) An alternative anti-avoidance legislation which is based on the current taxation of the basic interest component has to take into account a number of aspects, especially the following:

- The legislation must be applicable in a non-discriminatory manner to income generated by resident and non-resident entities in order to be in line with EU law.

- The determination of “tainted activities” in order to limit the application to capital services which entail an increased risk of tax avoidance. This reduces the scope of application to the activities in which the basic interest component plays an important role and reduces, at the same time, the administrative burden which may be caused by such legislation. The tainted activities should encompass financing activities, licensing activities, leasing and renting activities related to movable and immovable property, and any other activities which are related to the provision of capital which is utilised not by the company itself but by another party and which includes a financing element.

- The separation of the basic interest component from the total amount of income derived from the activities is quite complex and difficult. A simpler and more practical approach is the determination of a percentage which can be applied on the capital invested in tainted property. The benchmark for the determination of the basic interest component might be derived from the yield of high quality state bonds, inter-bank rates (e.g. Euribor) or European Central Bank basic rates. In my opinion, a compromise is required to bring together the requirements based on economic and equity principles and the anti-avoidance aspects. Such a compromise can be the determination of a rate which is applicable for the whole year instead of a rate which is adjusted regularly. Of course, such a rate will also include expectations, e.g. with respect to the development of the interest and inflation rate. From my perspective, the 12 months Euribor which is determined, as an average, for the month preceding the financial year for which the rate should be applicable can be an appropriate benchmark.

- The risk component is to be excluded from the current income taxation - as outlined above - if it can reasonably be assured that the system may not be circumvented or otherwise significantly manipulated to the detriment of the Member State which applies such legislation. Normally, this is not the case, but it may depend on the legislative framework of the Member State which applies such legislation. If necessary, the latter Member State has to amend its legislation in this respect.

- A consistent approach makes it necessary, in my opinion, that such legislation is not only applied to the direct shareholder in the company which carries on the tainted activities, but also to the ultimate resident - direct or indirect - shareholder. This can be an individual shareholder, a permanent establishment of a non-resident shareholder, or a corporate shareholder.

- The question has to be answered whether the alternative anti-avoidance legislation should only be applied to non-transparent entities or whether it should also be applied to transparent entities and permanent establishments. The reason is that the application of the exemption method for income derived by foreign transparent entities and permanent establishments can have an effect which comes close to the sheltering of income. However, the extension of the legislation to non-transparent entities and permanent establishments - with the consequence of a switch from the exemption method to the credit method - may result in a tax treaty override which, of course, has to be avoided. From an anti-avoidance perspective, the problem is reduced by the fact that the alternative legislation is also applied to indirect shareholdings - and therefore to the individual or corporate taxpayer behind the company which has a permanent establishment - and by the fact that the allocation of tainted activities to a transparent entity or permanent establishment is more difficult than in case of a non-transparent entity which is to be considered a separate legal entity.

- The alternative legislation should not be applied to each and every resident shareholder. A certain minimum threshold is necessary to ensure that the shareholder has sufficient influence on the activities of the respective company and to gather the information required for the current taxation of income. Here, it is important to find an appropriate balance between the necessity of an anti-avoidance legislation and the administrative burdens for the taxpayer. The percentage which was identified as an appropriate threshold is 25 percent. The threshold should be linked to the percentage of shareholding and the percentage of voting rights. Thus, if either the percentage of shareholding or the percentage of voting rights is reached or exceeded, the legislation should be applicable. The legislation does not require, in my opinion, an additional “absolute” financial threshold. In this respect, exemption provisions for minor investments can be provided.

- There is a need to define the persons who have to be classified as ‘related parties’ to the shareholder. In my opinion, the following persons have to be within in this category: (i) persons who are related through family membership, (ii) persons who are related through factual or contractual arrangements and (iii) persons who are related through shareholding structures.

- The stipulation of a minimum threshold makes it necessary to implement constructive ownership rules in order to avoid that the minimum percentage of shareholding or voting rights is circumvented.

10.) Therefore, based on the conclusions drawn in this chapter and in previous chapters, and taking into account the aforementioned aspects, I propose an anti-avoidance legislation which is based on the current taxation of the basic interest component. The main elements can be summarised as follows:

- The proposed concept shall be named “capital service company legislation” or “CSC legislation” since it is applied to capital service activities (tainted activities).

- The tainted activities are financing activities, licensing activities, leasing and renting activities related to movable and immovable property, and any other activities which are related to the provision of capital which is utilised not by the entity itself but by another party and which includes a financing element.

- The CSC legislation is applicable in a non-discriminatory manner to resident and non-resident entities which carry on tainted activities.

- The basic interest rate is to be derived from the 12 months Euribor which is determined, as an average, for the month preceding the financial year for which the basic interest rate should be applicable. This rate should be applicable for the whole financial year of the entity which carries on the tainted activities.

- The basis for the calculation of the attributable income is, in general, the average book value of the tainted property in the balance sheet of the CSC (*calculation basis*). However, adjustments have to be made if the book value deviates from the average economic value - based on the expected economic lifetime of the property concerned. Adjustments are also required in case of extraordinary write-downs and similar measures as well as in case of contractual provisions which lead to an increase or a decrease in the average amount of capital provided during the contractual period. The underlying assumption is that the economic value reflects the amortisation in an agreement which is based on the arm's length principle. The taxpayer has the possibility of providing the evidence that the value after amortisation is lower than the average economic value. The calculation basis does not necessarily reflect the fair market value of the respective property. What is important for the determination of the calculation basis is not a 'mark-to-market' value at specific points in time, but a value which reflects, as much as possible, the average amount of capital provided during the contractual period.

- In case the activities are (partly) debt-financed, the calculation basis has to be reduced. The percentage of equity-financed investments which are related to the tainted property has to be determined based on the ratio of the total average amount of equity to the total average amount of equity plus the total average amount of interest-bearing debts. The equity-percentage has to be applied to the calculation basis in order to end up with the *net calculation basis.*

- The CSC legislation is to be applied to direct and indirect participations in non-transparent legal entities and to permanent establishments of those entities as well as to the participations of the latter entities in transparent partnerships. The allocation of tainted and non-tainted property between the state of the headquarter company and the state of the PE (PS) follows the allocation which has to be made for income tax purposes.

- The CSC legislation applies to direct and indirect shareholdings of at least 25 percent (percentage of shareholding or, alternatively, percentage of voting rights). The requirement of a 25 percent threshold applies to the investment in the CSC itself, i.e. even in case of multiple-tier structures the shareholder is required to hold a participation of at least 25 percent in the CSC.

- The basic interest income is allocable to the shareholder after the end of the financial year of the CSC.

- The current allocation of income requires the application of an ordinary tax credit system which ensures a consistent relief from double taxation. The income attribution should not lead to a "penalty effect" for the shareholder, but should solely provide for the current taxation of the basic interest component. It is therefore required that the income attribution is separated from the regular domestic taxation of the shareholder and that the tax credit mechanism is modified. Without the latter separation and modification, the system might lead to a treatment which is, at least in some situations, less favourable compared to the treatment of income which is either derived directly by the shareholder or by a legal entity which is not subject to current taxation. This is particularly true in case of losses (of the shareholder, the CSC, or intermediate companies) and multiple-tier structures if different systems are applied simultaneously. Therefore, the proposed CSC legislation follows a concept which provides for the possibility of a *preliminary tax determination* and a *postponement of tax payments* in certain situations and under certain circumstances.

- The attributed income is subject to tax at the highest domestic (group) level. This can be a legal entity, an individual shareholder, or a permanent establishment of a non-resident investor (which therefore also encompasses transparent partnerships).

- If the income is attributed to an individual shareholder, it will be taxed at a flat rate which is derived from the domestic corporate income tax rate and not according to the (progressive) personnel income tax rate of the shareholder.

- The taxation according to the "regular" personnel income tax system of the individual shareholder will be made as soon as the income is actually distributed - with a full crediting of the previously imposed (preliminary) flat income tax. Finally, this ensures an identical treatment of currently attributed income and non-currently attributed income.

- The CSC legislation also provides for a consistent relief from double taxation in case of subsequent profit distributions and the subsequent disposal of shares.

- The system provides for a number of *exemptions* from the current taxation of income in order to reduce the administrative burden and to limit the scope of such legislation, as much as possible, to the situations and structures in which the risk of tax avoidance - from the perspective of the state which applies the CSC legislation - is increased. The exemption provisions have to be seen individually, i.e. if the conditions for one of the exemption provisions are fulfilled, there will be no income allocation under the CSC regime. The following exemptions have been proposed:

    - Exemption based on a property-ratio: an exemption should be granted if the non-tainted property in the balance sheet of the

CSC - based on book value - prevails. I have proposed a percentage which should be in a range between more than 50 percent (minimum) and more than 75 percent (maximum).

- Exemption based on an income ratio: similar to the property-ratio, an exemption should be granted if the income from non-tainted activities encompasses more than 50 percent (minimum) and more than 75 percent (maximum) of the total income of the CSC.

- Exemption based on the classification of the service recipients: the tainted activities should be exempt from current taxation of income if the services are provided - to a significant percentage - to unrelated parties. This should be the case if more than 75 percent of the income from tainted activities is related to services provided towards unrelated parties.

- Exemption based on a general financial threshold: in order to avoid that each and every minor amount of tainted investment is subject to current taxation, it seems to be acceptable to stipulate a financial threshold as an absolute amount. In my opinion, the threshold should refer to the net calculation basis of the tainted property (in total) and should be within a range of 100,000 Euro to 500,000 Euro. Thus, if the net calculation basis of the tainted property does not exceed the threshold, no income attribution is required.

- Exemption based on income taxation at source: in those cases in which the basic interest component is not subject to taxation in the state of residence of the service company, but in the state of source, there is no necessity to calculate the basic interest component.

- It is of utmost importance that the proposed CSC legislation complies with the idea and the concept of an internal market and primary and secondary EU law. The current taxation of the basic interest component under the CSC system clearly supports, in my opinion, the efficient allocation of capital among Member States and other countries and is therefore fully in line with the idea and the concept of an internal market.

- The main aspects to ensure the effectiveness of the legislation and the compliance with *primary* EU law are the following:

  - The limitation to tainted activities which entail - from the perspective of the state which applies the legislation - an increased risk of tax avoidance (capital service activities).

  - The application of the system in a non-discriminatory manner to tainted activities carried on through resident and non-resident entities.

- The strict limitation of the current taxation of income to the basic interest component.

- No difference in the treatment of the basic interest income which is caused by the tax credit system, existing tax losses, multiple-tier structures et cetera.

- The granting of non-discriminatory exemption provisions.

o *Secondary* EU law does not play a comparably important role. However, if the (revised) Parent-Subsidiary Directive is applicable to the current attribution of income under a CFC or CSC system, the respective system is required to provide for the elimination of double taxation either by applying the exemption method or the credit method. This is clearly the case for the proposed CSC legislation.

11.) The outcome of the *Cadbury Schweppes* case can provoke different reactions of Member States and may lead to an increased political pressure for the introduction of an EU wide minimum income tax rate or for comparable measures of harmonisation. The final outcome from a political perspective, however, is difficult to estimate and it is quite likely that a common European approach can only be achieved in the long run. The immediate unilateral reactions which can be expected - and which can already be noticed - are either the adjustment of CFC rules in a way which complies with the requirements derived from the *Cadbury Schweppes* case, or the extension of existing CFC rules to comparable domestic investments and investments in other (high-tax) countries. However, due to the fact that a concept which is based on the conclusions of the *Cadbury Schweppes* decision would change the scope of the legislation significantly, it can be expected that some of the regimes will rather be extended to resident and non-resident entities instead of providing an “escape clause”. The Council of the European Union published a Resolution on the coordination of CFC rules which recommends that Member States adopt some guiding principles for the application of these rules. However, the Resolution only presents a list of indicators for the identification of artificial arrangements. This can be helpful to align the approach of the Member States with respect to the separation of artificial structures from non-artificial structures - but not more than that.

12.) The CSC legislation only results in a conflict with a tax treaty which is based on the OECD-MTC if (i) the legislation is applied to income generated through a PE in the other contracting state and (ii) the tax treaty explicitly provides for the application of the exemption method (and not the credit method) in order to avoid the double taxation of PE income. Only in this case, it is required to explicitly refer to the application of the CSC legislation in order to avoid a tax treaty-override. However, it is apparent that the application of the CSC taxation is less “aggressive” - also in the light of the relationship with the other contracting state - than the typical CFC regimes which usually focus on all (vertical) income components. Together with the clear economic and equity reasons behind such legislation it seems to be less likely that the application of the CSC taxation results in serious conflicts with the other treaty partner. This should not be understood as a suggestion or a justification for a tax treaty-override, but it shows that the overall impact of such an override is very limited. One may even see it from a different angle: the fact that the CSC regime solely focuses on the basic interest component might open the door for an argument - supported by economic and equity reasons - to amend the respective double tax convention and to explicitly include the possibility of applying the CSC regime.

13.) It is important to understand and to highlight the main differences between CFC legislation - which is extended in the manner described above - and the proposed CSC legislation. The most significant aspects can be summarised as follows:

- The extension of a transactional approach CFC legislation to resident entities may lead to an extraordinary administrative burden, especially in those cases in which all types of income from inter-company services are in the focus of the respective legislation. For this reason, a substantial amendment to the legislation may be required.

- The extension of an entity approach CFC legislation may require a revised classification, too. The reason is that the income from inter-company services is typically treated as tainted income and, therefore, might lead to a complete income allocation if it encompasses a substantial part of the overall income of the CFC.

- The transactional and entity approach CFC legislation which applies to resident and non-resident entities - without focusing on the income tax rate - does not solve the problem of income allocation which is related to the activity component and the risk component of capital. The contrary is true: the extension of the system to medium- and high-tax countries increases the amount of "critical" income allocation.

- The increase in income allocation which is related to the activity component and the risk component is not limited to tainted income, but also "infects" non-tainted income if the CFC legislation follows an entity approach. This would lead to a massive extension of the taxation of income components which should be - based on the principles outlined in earlier chapters - exempt from current taxation.

- The extension of the CFC taxation would by no means solve the problems which are caused by the inconsistent application of the tax credit system, the asymmetrical allocation of income, the inclusion of the income in the tax base of the shareholder, et cetera. It might even lead to *additional* conflicts. The latter can be the case, for example, if the domestic legislation provides a system of fiscal unity (fiscal consolidation) only for domestic entities: the exclusion of negative income of a non-resident CFC from an offsetting with positive income of the shareholder, on the one hand, but an offsetting of negative income of a resident CFC under the fiscal unity regime, on the other hand, would lead to a situation which, in my view, is not in line with the concept and the idea of an internal market.

- A simple extension of CFC rules to resident entities is, in essence, not sufficient to fulfil the needs and the requirements of an internal market - even if the extension is implemented in a manner which leads to a non-discriminatory legislation and may therefore theoretically be in line with the basic freedoms of the TFEU.

- The CFC legislation often focuses on the lowest domestic group level, i.e. does not allocate the income to the ultimate domestic shareholder. This opens the possibility for structures which minimise the anti-avoidance effect. In contrast thereto, the proposed CSC legislation focuses on the shareholder on the highest domestic group level, be it an individual shareholder or a corporate shareholder.

- The mechanism of CFC legislation can result in significant distortions, with the effect that the overall tax burden caused by the CFC income allocation is higher than a comparable dividend distribution. The CSC legislation is based on a two-step approach: first, the current allocation of the basic interest component and, second, the regular dividend distribution (or the disposal of shares). Both steps are linked closely in order to avoid any double taxation of income.

- The proposed CSC legislation follows an approach which is “softer” compared to CFC legislation, but without being less effective. The system focuses on the direct and indirect shareholder, but taxes the basic interest income only if the income is finally subject to tax in the CSC state. The system provides for postponements of tax payments and preliminary assessments to ensure the avoidance of double taxation, and to ensure that currently attributed income is not treated worse than any other income which is not subject to current taxation (no “penalisation” of the shareholder).

Part IV - Concluding Observations

10. Summary and Conclusions

10.1. Purpose of the Study

10.1.1. Working in the field of international taxation, questions related to CFC legislation (which, in the following, also encompasses FIF legislation - if the latter legislation is not mentioned separately) are of great practical relevance. International investments and restructurings can become less attractive - or even unattractive - just because of the application of CFC regimes. This is not only true for the generation of typical “passive” income like interest and royalties, but also for the relocation of group operations to other states which may lead to “base company income.” It is therefore apparent that the application of CFC regimes can have a major impact on the international activities of a taxpayer. It is equally apparent, in my opinion, that it is unacceptable that the state of the shareholder taxes all of the income derived through a foreign entity on a current basis. One has to keep in mind that the income usually also encompasses elements of income which are produced in the CFC state or where the CFC takes over substantial risks. Moreover, in an European Union context it is obvious, based on the case law of the European Court of Justice, that Member States cannot - at least not without justification - restrict the foreign activities of their residents. The outcome of the *Cadbury Schweppes* case clearly shows that this is also of great importance for the application of CFC regimes.

10.1.2. The fact that a number of Member States still follow the “typical” CFC regimes makes the research in the European context particularly interesting. This became already clear when I was working on my Master thesis at the European Tax College in Leuven, which was mainly focused on the comparison of European CFC regimes. From my perspective, it is obvious that the typical CFC regimes are “outdated” and not ready for an application in an internal market. The CFC regimes require alternatives which accept the (limited) necessity of an anti-deferral approach but which are, at the same time, acting within certain legal and economic parameters. With this PhD thesis I would like contribute to the ongoing discussion on the changes or even the abolition of CFC regimes and would like to provide an alternative concept to the existing regimes.

10.1.3. One of the decisive questions in this context is the question whether the principle of capital import neutrality or the principle of capital export neutrality should be the prevailing principle in the taxation of foreign source income. If one comes to the conclusion that the principle of capital import neutrality should be the prevailing principle not only for the taxation of income from direct investments but also for income from portfolio investments, there is an obvious conflict with the excessive current taxation of income under most of the existing CFC regimes. The problem, though, is the fact that the OECD-MTC, as one of the most important international patterns for the conclusion of double tax conventions, is fostering the residence-based taxation of certain passive and base company income. Such an approach is therefore rather supporting the relocation of certain capital intensive activities to states and territories which provide for a lower taxation of income. Thus, the general acceptance of the principle of capital import neutrality does not necessarily mean that there is no need for a “limited” taxation according to the principle of capital export neutrality. However, not all of the income components have to be treated identically, since not all of them have to be safeguarded from a competitiveness point of view. It is quite important, under the circumstances outlined above, to deviate from the existing transactional and entity based CFC regimes towards a new concept which is much more linked to the principle of capital import neutrality and the aim of fostering competitiveness. It is apparent, in my opinion, that this cannot be achieved by a mere horizontal separation of income, like in case of the transactional regimes, but requires, in addition, a vertical separation of income. In order to determine such a new concept, it is important to identify and to determine the economic and legal basis, the possibilities and limits from an EU law perspective and the basic requirements from an anti-avoidance point of view. It is also important to examine the various types and the specific elements of the existing CFC rules as well as the interrelation with double tax conventions.

10. 2. Economic Principles in International Taxation

10.2.1. From an economic point of view, the basic question is whether the principle of capital export neutrality should prevail over the principle of capital import neutrality, i.e. the concept of efficiency over the argument of competitiveness, or vice versa. It can be concluded that the efficient allocation of capital is distorted by several factors and it seems to be obvious that complete neutrality cannot be achieved. Therefore, the principle of export neutrality not only fails to achieve complete neutrality but does also have a negative effect on competitiveness. In a world of globalisation and of different tax rates and tax systems it seems to me that the creation of an environment which clearly fosters competitiveness, i.e. a tax policy which allows companies to compete at equal terms in a respective market, would probably be the best and most realistic way to maximise global welfare. Such an environment can be achieved by following the principle of capital import neutrality and the application of a source-based taxation - in contrast to a residence-based taxation which reflects the principle of capital export neutrality. In general, this is not only true for foreign direct investments but also for portfolio investments.

10.2.2. The safeguarding of competitiveness is especially relevant in two cases. First, where an international company operates in a foreign market and has therefore to compete with local companies and subsidiaries of other multinational enterprises and, second, where an international company separates and relocates functions and risks to other foreign companies. In both cases it is important that the profits related to those functions and risks are not taxed more heavily in comparison to third party activities in the respective foreign market.

10.2.3. The case of a relocation of functions and risks may result in the establishing of services which are mainly based on the provision of capital such as financing services, leasing services, and licensing services. As a consequence thereof, inter-company income streams are created which include a separable interest component related to the capital provided and this interest component is one of the most important components of the overall compensation. For this reason, I consider the creation of capital-intensive inter-company services by allocating those functions and risks to separate legal entities to be a kind of "hybrid investment." It is called hybrid investment because it combines the elements of a *direct investment* - by incorporating a subsidiary (service) company in another state - and the elements of an *indirect investment (portfolio investment)* - by focusing on the provision of capital in return for (indirect) interest payments. In other words, such investments lead to a relocation of functions and risks which are mainly related to capital-intensive services - with a separable interest component - and which are utilised by another party, i.e. the capital is not *directly* employed for an income-producing activity of the subsidiary, but for an income-producing activity of the recipient of the services (which can be a related or unrelated party). The subsidiary, of course, realises income from the provision of capital, but not from the *direct* utilisation of capital in an income-producing process (of the subsidiary).

10.2.4. Also in case of hybrid investments, the general conclusion should be that the interest income is to be taxed in the state in which the latter is produced. However, this is very often not the case, especially where the double tax convention between the state of the service company and the state of the recipient of the services is based on the OECD-MTC. In such a *non-optimal scenario* of a residence-based taxation the question arises whether all or part of the interest component included in the income should be taxed in the residence-state of the subsidiary (service) company or whether it could be equally taxed in the residence-state of the parent company. This question does not arise for additional functions exercised and risks taken by the respective parties. The income related thereto is clearly allocable - from an economic point of view - to the respective company which exercises the functions and which takes over the risks directly. The income which is related to the separable financing element, however, has to be split up into a basic interest component and a risk component.

10.2.5. The basic interest component consists of the actual real interest rate and the actual inflation rate on a “rolling” basis, i.e. on the basis of permanent adjustments. In my opinion, the basic interest component is the minimum interest rate which can be achieved by an investor. It reflects a totally flexible investment which does not include any expectations and any risks related to the debtor and the time of investment. The basic interest component is strongly connected to the capital itself, even though it must be produced - just like any other income - by the recipient of the capital investment. Essentially, this component increases the wealth of the investor by the permanently adjusted real interest rate of a variable investment, because the inflation premium covers, in this situation, exactly the devaluation of money. In general, the basic interest component can be seen as an isolated component or as a component which is embedded in the total amount of interest income (together with the risk component).

10.2.6. The risk component encompasses the elements which are based on *expectations*, e.g. the premium for an expected increase in the real interest rate and the expected increase in the inflation rate (in case of an investment which binds the investor for a certain period of time and where the interest rate is fixed). In case of an expected decrease in the latter elements, this may result in a reduction of the existing basic interest component (within the fixed interest rate). The risk component also includes the liquidity premium and the premium which is required to cover the risks related to the debtor. Theoretically, there should be a balance between the risks assumed by the investor and the compensation for those risks included in the interest income. The coverage of the risk does not necessarily require the direct connection to the capital investment, i.e. the risk coverage could theoretically be separated (or “stripped”) from the latter investment. This is particularly true for the risks which are related to the debtor, e.g. by way of a guarantee.

10.2.7. Overall, it can be concluded that the interest income encompasses two very different types of components: the basic interest component, which can only be derived because of the provision of capital - and which is therefore strongly connected to the capital itself - and the risk component, which has to cover all of the potential risks which are caused by the debtor and the period of investment.

10.2.8. The risk component included in the interest income is to be treated in the same way as other functions and risks and is therefore - in the non-optimal scenario - allocable to the company which takes over the risks directly and should therefore be taxed in the respective state. In contrast thereto, the basic interest component included in the income is strongly connected to the capital itself. Thus, there is no preference whatsoever for a taxation of the basic interest component in the residence state of the finance or leasing company from an economic point of view. The residence state of the shareholder (parent company) should therefore, from an economic perspective, have the right to currently tax the basic interest component. In the absence of a strict source-based taxation, the safeguarding of competitiveness requires that the overall tax burden does not exceed the result which would theoretically be achieved in an optimal economic scenario. The taxes imposed on the basic interest component should therefore be restricted to the theoretical tax burden in the income-producing state. Of course, the allocation of taxing rights deviates from the optimal economic scenario and this cannot be corrected. However, the overall tax burden on a *group level* - not on the level of the separate legal entity - would be comparable and would therefore not worsen the position of the group from a competitiveness perspective. In my opinion, there is no economic necessity to provide for a lower taxation of the basic interest component than the taxation in an optimal economic scenario of a source-based taxation. Such a lower taxation would even exceed what is actually required by the argument of competitiveness. One could even go one step further: the low-taxation on the level of an intermediate company in hybrid structures could have a distorting effect on the allocation of capital. In theory, this requires the basic interest income to be taxed in the hands of the low-tax company at a rate which is as high as the comparable tax rate in the source-country. If this is not the case, the higher taxation in the state of the parent company can have a positive effect with regard to the efficient allocation of capital and therefore also on competitiveness in general. However, this requires the limitation of the taxation of the basic interest component in the state of the parent company to the rate applicable in the source country. In addition, the state of the parent company has to provide for a crediting of the taxes levied on the income of the subsidiary company in order to avoid any double taxation. Thus, any taxation of the basic interest component in the state of the parent company may therefore be regarded as a partial and strictly limited application of the principle of capital export neutrality. However, such a current taxation in the state of the parent company - in addition to the taxation in the state of the intermediate service company - should not result in an “over-taxation” of income. For this reason, there should be a strict limitation to the actual income derived from the respective activities in the state of the intermediate service company (as a maximum). For example, if the (net) interest income from the financing activity of the service company is only 2 percent, e.g. because of the revaluation of the loan receivable or the interest receivable, the maximum amount of current taxation should be 2 percent - even if the basic interest component is 4 percent. If the activity results in a negative income, nothing should be allocated.

10.2.9. The basic interest component should be taxed in the state of the shareholder (parent company) on a "rolling" basis, i.e. not just the basic interest rate which is applicable at the moment of making the investment (or the stipulation of a fixed interest rate) but also any subsequent increase or decrease. Of course, any subsequent development is part of the risk which is covered by the risk component and one might argue that this results in a kind of "overlapping" of the taxation of the basic interest component and the risk component. However, in this respect it is important to note that any premium included in the (fixed) interest rate in order to cover such a risk is, in principle, only taxed in the state of the service company. The fact that any increase or decrease in the basic interest component is subject to current taxation in the state of the shareholder does not influence the taxation of the premium. Moreover, it has to be accepted that - with regard to the basic interest component - there are two different perspectives: the perspective of the state of the service company, where the expected increase or decrease has to be stipulated within the (fixed) interest rate, and the state of the shareholder which focuses on the taxation of the risk free component of the capital investment (minimum taxation). Both perspectives have to be recognised and accepted. However, it is important, as already outlined above, that (i) the taxation in the state of the (subsidiary) service company and the state of the shareholder (parent company) is limited to the tax rate applicable in the state in which the interest income is produced and (ii) that any current taxation of the basic interest income is limited to the amount of actual income derived in the state of the (subsidiary) service company.

10.2.10. It has to be emphasised that a distinction is to be made between functions where the interest component can be considered to be a separable part of the activity, e.g. finance and leasing activities, and functions where the interest component is only theoretically included in the overall economic output. In the latter case, the interest component is just a part of a - more or less - complex process of exercising a certain function. A theoretical separation of the interest component and a partial allocation to a parent company is therefore economically not justifiable and not required. The interest component in the latter case is a necessary element to "create" the services or produce a certain amount of income but it is not a separable part of the services itself. The portion of income which is theoretically related to the basic interest component is - in this particular case - produced in the state of the intermediate (service) company. In other words, the income produced by the exercising of functions should be taxed in the respective state. Any other solution would negatively influence competitiveness. This is irrespective of the "way" how the income is created and the elements which are necessary to produce the income.

10.2.11. In case of portfolio dividends and capital gains of portfolio investments in shares the taxation should be limited to the taxation of the underlying profit realised by the foreign company which produces the income. Any deviating residence-based taxation of a foreign intermediate company does not justify a residence-based taxation of the shareholders in the intermediate company on a current basis. In contrast to interest income, the underlying income is already taxed in the source state and there should be no additional taxation in the residence state. In other words, even if the intermediate company taxes the dividends and capital gains with a relatively low income tax, this will not justify any additional taxation on a current basis. Moreover, the idea of a "basic interest component" does not play any role in this context. In contrast to the taxation of interest income the taxation of the underlying business profits actually occurred "at the right place" from a competitiveness point of view, i.e. in the country where the business activities are carried on. This is true for the whole profit generated and there is - in my opinion - no room and no necessity to calculate any theoretical basic interest component in this situation.

10.3. Legal Principles in International Taxation

10.3.1. Equity aspects require a source-based taxation rather than a residence-based taxation of direct investments. The same should be true with respect to portfolio investments.

10.3.2. The OECD-MTC generally provides for a residence-based taxation of dividend income, interest income and royalty income. In case of dividend and interest income the OECD-MTC provides for a limited taxation at source. Business profits are taxable in the residence state as long as no permanent establishment exists in the other contracting state.

10.3.3. The allocation of taxing rights based on the OECD-MTC supports, in my view, the creation of hybrid structures in which service companies of any type are implemented in an international group structure. Those service companies are often incorporated in low-tax countries, i.e. the international group can take advantage of the lower level of taxation which is generally possible because of the residence-based taxation in the low-tax country and the limited source-based taxation in the high-tax country. Those service companies should in general be taxed in the state in which the business functions are exercised. This is typically the residence state of the service company as long as no permanent establishment exists in the other contracting state. The functions have to be measured on an arm's length basis. This should be in line with equity considerations.

10.3.4. Interest income should be taxable in the source state. In this respect, the source state has to be seen as the state in which the income-producing activity is carried on and in which the income which is the basis for the interest payment is actually "created." If this is the case, the income related to an equity investment and the income related to a loan investment are treated in a comparable manner for tax purposes. This would also lead to an equal treatment of resident and non-resident investors which would both be subject to tax in the state of source. Both types of investors would be taxed according to the benefits received and both would be in a comparable position to compensate for the risks inherent in the business activities carried on in the source state. However, since the OECD-MTC provides for a residence-based taxation of interest income (and a limited taxation at source), this can be considered - in my opinion - to be a *non-optimal scenario* from an equity point of view. In such a non-optimal scenario, the interest income has to be split-up into a risk component and a basic interest component (risk-free component). The income which is related to the risk component should be taxable in the same way as the exercising of business functions, i.e. in the state where the risk is taken directly, which is typically the state in which the service company carries on its activities (e.g. in case of a hybrid investment). The basic interest component, however, should be allocable to the state where the invested capital comes from. The reason is that in the absence of an optimal scenario of a source-based taxation, the comparison between resident investors becomes decisive. In this respect, equity aspects require a comparison either between resident individuals or a comparison between resident corporations. A direct comparison between resident individuals and resident corporations can only lead to an appropriate result if the differences in tax treatment between individuals and corporations are taken into account.

10.3.5. In a non-optimal scenario, the equal treatment of taxpayers makes it necessary to currently allocate the basic interest component to the resident taxpayer. In general, this should be the ultimate individual shareholder who provides the capital for the investment. Any other approach supports the sheltering of the risk-free interest component of capital. This might even be true in case of an interposition of a *resident* intermediate (holding) company. In my opinion, the absence of a current taxation of income in case of an identifiable basic interest component - within the aforementioned described hybrid structures - would result in an unequal treatment of resident individual investors. However, it is equally clear that the current taxation of income should not encompass any other income components apart from the basic interest component. The reason is that the other income components are either related to functions carried out or to risks assumed by another taxpayer. This conclusion is not dependent upon the fact whether, for example, an intermediate (holding) company actively carries out business activities or whether the individual shareholder has a decisive influence on the activities of the holding company and any other subsidiary companies.

10.3.6. The taxation of the basic interest component should follow the concept described above with regard to the economic principles in international taxation. Based on these principles, the basic interest component should be taxed on a “rolling” basis, i.e. the increase or decrease over the period of investment is to be taken into account. This ensures the taxation of the risk-free (minimum) income in the state of the shareholder. However, the taxation of the basic interest component must be limited (as a maximum) to the positive income derived by the intermediate service company. Any other approach might lead to the taxation of income which is not existent.

10.3.7. Royalty and leasing income has to be separated into four different parts: a compensation for write-offs of the property concerned, a compensation for maintaining the property, a compensation for bearing the risks, and an interest component. Consequently, the income related to the first three components should be taxed in the country where the service company carries on the income-producing activity. The interest component included in the payments should be treated in the same way as the interest income outlined above. Theoretically, a separation of the interest component from the other components could be made by stipulating a certain percentage of the payments which should reflect the interest component and which should be taxed in the source state. The percentage could be stipulated by protocol or mutual agreement or, alternatively, a standard could be included in the double tax convention. However, the OECD-MTC provides for a residence-based taxation of the total amount of income without separating the income into the different elements.

10.3.8. In case of dividends and capital gains derived from portfolio investments in shares, the taxation should be limited to the source state. Contrary to the interest component included in interest payments, royalty payments or leasing payments, the profit underlying the dividends and capital gains is already taxed in the source state. Thus, a subsequent taxation of the dividends or capital gains is not required by equity aspects.

10.3.9. Overall, the concept of a current taxation of the basic interest component in the hands of the resident taxpayer is supported by economic and equity principles. Both, economic and equity aspects, require - in principle - that the foreign income should be taxed in the state in which the income-producing activity is carried on. However, if this optimal result cannot be achieved, other aspects have to be taken into consideration. Therefore, if a residence-based taxation leads to a shifting of taxing rights, with the effect that the income is not taxed in the state in which the income is produced but in the state in which the capital is legally concentrated, it is necessary to separate the basic interest component - which is neither related to the exercising of certain functions nor to the taking over of risks in the state of the intermediate company - and to allocate this interest component to the state the capital comes from. The taxation itself should theoretically be limited to the tax burden applicable in the state of source. The latter is true for both, the current taxation of the basic interest component in case of an indirect financing structure (via an intermediate company) and the taxation in case of a direct loan investment. The reason for such a limitation is the fact that this is, in my opinion, the only possibility to support the competitiveness of the group within a non-optimal scenario of a residence-based taxation. Without such a limitation, the group might be subject to a higher taxation than in case of a strict source-based taxation (at least with respect to the basic interest income) and would therefore face a competitive disadvantage on a group level. In other words, if the optimal result cannot be achieved, the overall tax burden imposed on the basic interest component should not exceed the income tax rate which would be applied in case of a taxation at source. In this case, the resident investor would be treated in the same way (with respect to the overall tax burden imposed on the basic interest component but not with respect to the countries imposing the income taxes) no matter whether the financial means are provided through (i) a direct loan investment, (ii) an indirect loan investment (or a similar investment which contains a separable financing element) - through the interposition of an intermediate company - or (iii) an equity investment in the company which produces the income (with respect to the comparable amount of income). In my opinion, this is - from an equity perspective - the most preferable result within a non-optimal scenario of a residence-based taxation. Such an approach is therefore not only supported by the economic principles, but is also supported by equity considerations. In essence, it leads to a partial and strictly limited application of the principle of capital export neutrality.

10.4. European Union Law

10.4.1. The case law of the ECJ shows that the investment in another Member State may be protected, in principle, by the freedom of establishment, the freedom to provide services and the free movement of capital.

10.4.2. The concept of establishment was described by the ECJ as the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period. The case law of the ECJ shows further that - in order to come within the scope of the freedom of establishment - the secondary establishment (e.g. in a legal entity) must confer definite influence over the company’s decisions.

10.4.3. Not each and every activity can be considered an economic activity. In order to come within the scope of the freedom of establishment, an economic output must exist which is created in the host Member State. The mere holding of assets or shares cannot be seen as the pursuing of an economic activity, but assets and shares can be seen as an “instrument” which may be utilised to carry out economic activities.

10.4.4. The economic activity must be pursued through a fixed establishment. Based on the case law of the ECJ, such an establishment requires (i) the appearance of permanency, (ii) a management and (iii) has to be materially equipped for the carrying out of the respective functions. Essentially, the establishment must be sufficiently equipped (premises, management, staff, equipment) in order to provide the respective services or any other functions on its own and without being a mere tool of execution of, for example, the parent company.

10.4.5. In order to have a definite influence over the company’s decisions and to determine its activities it is not necessarily required that a single shareholder has a majority interest in the company. In the *SGI* case a shareholding of 34 percent was sufficient to come within the scope of the freedom of establishment. The ECJ case law shows that even a combination of relatively low minority holdings of about 10 to 12.50 percent per shareholder, like in *Columbus Container*, can be sufficient if further elements are existent which show that a definite influence exists. This is the case, for example, if shareholders act together, e.g. by a common representative, and the (combined) shareholding confers such a definite influence. In general, no clear percentage of shareholding or voting rights can be derived from the case law. In my opinion, the national commercial and company law has to be referred to, but it seems to be apparent that a definite influence may also exist on a factual or contractual basis.

10.4.6. The freedom to provide services requires the actual pursuit of an economic activity from either within the Member State of primary establishment towards the recipient in another Member State or with a temporary link to the Member State of the recipient of the services. Apparently, the freedom of establishment and the freedom to provide services both require the actual pursuit of an economic activity. Hence, there is a certain overlapping of the requirements to come within the scope of the latter two freedoms. Nonetheless, it is unlikely - at least for investments in the context of this study - that two activities will be covered simultaneously by the freedom of establishment and the freedom to provide services.

10.4.7. The scope of the free movement of capital is much broader than the scope of the freedom of establishment (and basically also the freedom to provide services) and also encompasses any type of portfolio investments. A significant difference to the freedom of establishment is therefore the fact that - in order to come within the scope of Article 63 of the TFEU - the investment in a company in another Member State neither requires a definite influence over the company’s decisions nor the actual pursuit of an economic activity. Moreover, it is important to note that the scope of the free movement of capital is not limited to investments in other Member States but Article 63 of the TFEU is equally relevant for investments in non-member states.

10.4.8. The decisive question in a situation in which the basic freedoms are theoretically affected simultaneously is whether there is a certain form of order among these freedoms and whether there is a prevailing freedom which takes preference over another freedom (or other freedoms). The outcome of the examinations of the TFEU and the case law of the ECJ can be summarised as follows:

- *The freedom of establishment vs. the free movement of capital:* the more recent case law of the ECJ provides a better understanding of the relationship between these two freedoms. Based on this case law, the purpose of the national legislation must be considered for the decision which of the basic freedoms is affected. If the purpose of the legislation is the application to investments which confer a definite influence over a company's decisions, it is the freedom of establishment which is to be exclusively examined. The purpose of the legislation can be identified not only by quantitative elements (e.g. percentage of participation), but also by qualitative elements (e.g. collaboration of shareholders to achieve a definite influence). If the purpose of the legislation is the general application to all types of portfolio and entrepreneurial investments, the freedom of establishment and the free movement of capital can, in principle, both be affected. However, if the actual investment confers definite influence over a company's decisions and the purpose of the legislation is linked to the objective of exercising the freedom of establishment, the ECJ - in its examination - gives preference to the freedom of establishment. In contrast thereto, if the link does not exist and the '*free movement of capital aspect'* prevails, the ECJ gives preference to the free movement of capital. If the examination results in the conclusion that a restriction on one of the freedoms exists which cannot be justified, the ECJ refrains from additionally examining whether the TFEU provisions on the other freedom also preclude the respective legislation.

- *The freedom of establishment vs. the freedom to provide services*: the case law of the ECJ made it clear that the freedom of establishment does not necessarily prevail over the freedom to provide services. In *Fidium Finanz* the ECJ held that Article 57 (1) of the TFEU relates to the definition of the notion of 'services' and does not establish any order of priority between the two basic freedoms. In the *Cadbury Schweppes* case, the ECJ concluded that - with respect to the UK CFC legislation - the restrictive effects on the freedom to provide services are an unavoidable consequence of any restriction on the freedom of establishment.

- *The freedom to provide services vs. the free movement of capital*: In the relationship between Article 56 of the TFEU and Article 63 of the TFEU it is - again - the more recent case law of the ECJ which provides a clearer picture. Based on this case law, it seems that the purpose of the national legislation is decisive. If the national legislation clearly focuses on services, e.g. the supervision of services, there is apparently no room for any (additional) examination of the free movement of capital. On the other hand, one should also conclude from this jurisprudence that national legislation which is foremost directed towards the investment (as such) - and not the services provided by the investment (e.g. the respective legal entity) - the prevailing freedom should be the free movement of capital and not the freedom to provide services.

10.4.9. It is obvious that the fact that one basic freedom may prevail over another basic freedom can have important consequences. The most important consequence is, in my opinion and in the context of this study, related to the free movement of capital: the latter freedom is the only basic freedom which can also be invoked in case of investments in non-member states. Thus, if another freedom prevails over the free movement of capital - with the effect that Article 63 of the TFEU cannot be invoked anymore - the door for a protection of the investment in a non-member state (based on the TFEU) is closed. However, what is clear from the more recent case law is the fact that the purpose of the national legislation remains the decisive element for the decision whether the freedom of establishment or the free movement of capital will be examined. Consequently, if the national legislation is not linked to the objective of exercising the freedom of establishment and the '*free movement of capital aspect'* prevails, there will be an exclusive examination of the free movement of capital.

10.4.10. Given the importance of the basic freedoms for individuals and entities, it is obvious that situations exist in which the basic freedoms are abusively invoked just for the purpose of taking advantage of these freedoms without being entitled to do so. It is equally obvious that Member States apply rules in order to prevent such situations. However, the case law of the ECJ shows that the abuse of the basic freedoms must be determined case-by-case and cannot be generalised. In my opinion, the case law with respect to VAT does not lead to another outcome.

10.4.11. There are a number of justifications for a restriction on the exercising of the freedom of establishment, the freedom to provide services and the free movement of capital. The justifications are either included in the TFEU itself or can be derived from the case law of the ECJ. The latter justifications are recognised under the rule of reason as overriding reasons of public interest and are of great importance, especially in cases dealing with direct taxation. The examination was mainly concentrated on justifications based on the rule of reason which have already come up in previous decisions and which might somehow be relevant in the context of this study.

10.4.12. The examination shows that there are limited possibilities for the Member States to justify restrictions on the aforementioned basic freedoms. Some justifications have never been accepted, especially those which were merely based on budgetary or economic reasons, including justifications based on the erosion of the tax base and the loss of tax revenue, as well as the general compensation for advantages. Administrative inconvenience was rejected by the ECJ in earlier cases, but from the more recent case law one might have the impression that the ECJ is more open now for arguments which are linked to administrative inconvenience. A justification based on a different taxation in another Member State must be seen in the context of the respective national legislation. If it comes close (or is even identical) to the argument based on the erosion of the tax base, the loss of tax revenue or the general compensation for advantages, it cannot be accepted as a valid justification. The principle of territoriality and the protection of a balanced allocation of power to impose taxes between Member States were both accepted by the ECJ and might play a role in future decisions as well. Other justifications, like the cohesion of the tax system, the effectiveness of fiscal supervision or the aim of preventing tax avoidance, can be acceptable under certain - very limited - circumstances. The reason is that restrictive measures applied by the Member States have to be appropriate for the protection of the recognised public interest and proportionate to the aim pursued. They cannot go beyond what is necessary to achieve the aim of the provision. Thus, Member States are required to apply those measures which are the less restrictive to achieve the aim pursued.

10.4.13. With regard to the justifications, it is clear from the case law of the ECJ that it can be necessary to make a differentiation between an investment in a Member State and an investment in a non-member state. In other words, it may be the case that a restriction on the free movement of capital to or from third countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States. The movement of capital to or from third countries takes place in a different legal context from that which occurs within the EU, e.g. with respect to the application of the Council Directive 77/799/EEC. Nevertheless, a Member State may have concluded double tax conventions and / or other agreements with third countries which may result in legal obligations which are comparable to those which are existent in the EU. In this case, it may be difficult for a Member State to demonstrate that a justification is to be "weighted" differently. Therefore, the differentiation is not limited to the question whether the country of investment is a Member State or non-member state, but also requires a differentiation among the non-member states. However, it is clear that the national measure must still be proportionate in relation to the aim pursued, no matter whether it is related to Member States or non-member states.

10.4.14. From the perspective of secondary EU law it is the Parent-Subsidiary Directive which might be of general importance. In my opinion, the examination of the Parent-Subsidiary Directive and the jurisprudence of the ECJ in this respect shows that the classification of dividends - in the sense of the latter Directive - must be made according to objective characteristics and irrespective of the classification of dividends under the national legislation of the Member States. In principle, this covers regular and hidden dividend distributions.

10.5. General Aspects of CFC and FIF Legislation

10.5.1. The current taxation of income which is derived by a non-transparent foreign legal entity in the hands of the resident shareholder is the basic feature of CFC taxation in all of the countries which apply such a regime. Such an approach is somehow "unique" and - in substance - a deviation from the principle that a foreign legal entity is to be considered a separate taxpayer.

10.5.2. Almost all of the countries which follow a typical CFC legislation apply three basic requirements which have to be fulfilled for the application of their rules: (i) the foreign entity must derive certain passive income, (ii) there must be an ownership in the foreign entity, and (iii) the foreign income must be subject to low-taxation.

10.5.3. The FIF rules can basically be seen as a part of (or a supplement to) the CFC rules. The main differences can be described as follows: (i) FIF rules already apply to very small and insignificant shareholdings, whereas the CFC rules require in most cases a participation of at least 10 percent or more, and (ii) FIF rules are often only applicable to certain types of passive investment income but not generally to the wide range of passive income which is in the scope of CFC taxation.

10.5.4. The CFC rules can be seen as anti-avoidance measures in order to target the deferral of domestic taxation on foreign source income (anti-deferral measures). The CFC taxation leads to a limited application of the principle of capital export neutrality.

10.5.5. The deferral of domestic taxation can only partially be seen as a "privilege." The income which is related to the functions exercised and the risks taken by the foreign entity should be taxable in the residence state of the CFC. At least, this is required by economic and equity aspects. However, this can be different with respect to the risk-free interest component of capital included in the passive income. To the extent that the risk-free interest component is theoretically separable from the total income, there is no necessity for a deferral of domestic taxation. Thus, the deferral which is related to the (theoretically separable) risk-free interest component of capital can be seen as a privilege rather than a necessity.

10.5.6. The deferral of domestic taxation is, of course, of particular relevance where the income distribution is subject to tax in the state of the shareholder, e.g. where the residence state of the shareholder applies the credit method for the avoidance of double taxation. However, even if the distribution is exempt from taxation, a significant difference in tax rates can lead to the outcome that financial means are not repatriated to the parent company but retained on the level of the subsidiary company and are used for other activities, e.g. the financing of other group companies (including the parent company). Therefore, the non-distribution of financial means reduces the possibility of the parent company to create and increase taxable domestic income.

10.5.7. Other existing anti-avoidance measures do not have an effect comparable to CFC taxation. Some of the alleged alternative measures can in fact limit the advantage of foreign passive investments in low-tax countries and can create an obstacle for abusive investments, but none of the measures really targets the deferral of domestic taxation and therefore they cannot be considered a substitute for CFC taxation.

10.5.8. The income allocation as such is - in my opinion - in line with the ability-to-pay principle. This should even be true for minority shareholdings. The increase in value of the property which leads to passive income improves the ability of the shareholder to pay taxes. However, this is only true if the income allocation is equally relevant for positive and negative income. If the attribution is legally or factually limited to positive income, the CFC taxation cannot be in line with the ability-to-pay principle.

10.5.9. From a technical point of view, the CFC taxation is quite similar to the taxation of permanent establishments (PE) and partnerships (PS) according to the credit method. It seems to be necessary that a country which applies a CFC taxation to foreign legal entities requires a comparable system for the taxation of PE and PS if the income is otherwise exempt from taxation. However, countries may deviate from the OECD principles of an unrestricted functional allocation of property and income, which might be particularly relevant for passive investments and intra-group activities. For example, the German concept of what is called *the central function of the head office* clearly restricts the relocation of holding, financing and licensing activities to a PE. Under the German approach it is basically impossible to allocate the property of the latter activities to a PE. If these activities are carried out by the PE, the income allocation will be limited to a (service) fee for the coordination and the handling of the activities, but will not encompass the complete amount of income related to these activities. The latter is also true if the holding, financing and licensing functions are combined with other (active) activities which are carried out by the PE. In my opinion, the deviation from the OECD approach of an unrestricted functional allocation in case of certain activities is not justified and is to be rejected.

10.5.10. The OECD Report on Harmful Tax Competition recommends the introduction of CFC and FIF rules as counteracting measures against harmful tax competition. The EU Code of Conduct does not provide any specific recommendations, but recognises that such counteracting measures against harmful tax competition play a fundamental role. It seems that both, OECD and the Council, consider the CFC and FIF taxation to be an important tool to target harmful tax competition, even though the measures are equally applicable to low-tax regimes which are far from being harmful.

10.6. The Various Types and the Specific Elements of European CFC and FIF Legislation

10.6.1. In principle, the CFC and FIF regimes follow a very similar pattern. It has to be noted, though, that based on the *Cadbury Schweppes* decision of the ECJ, several Member States made amendments to their CFC and FIF legislation which result in a deviation from the original pattern. These amendments are of particular importance from an EU law perspective and, therefore, will be outlined separately. In the following, I will typically use the term “CFC”, which covers CFC and FIF legislation.

10.6.2. The countries which apply a transactional approach have a similar understanding of what is to be considered “passive” income in the context of CFC taxation, e.g. rental and leasing income, interest income, and royalty income. The common features of these passive activities are, amongst others, the fact that the income which is related to these activities is, at least to a large extent, not taxed in the state in which it is produced - as it would be required by the economic principle of capital import neutrality - but in the state of residence of the CFC. This is due to the allocation of taxing rights stipulated in the double tax conventions which follow the pattern of the OECD-MTC. Moreover, the activities are usually capital intensive activities. The portion of income which is related to the interest element is therefore increased. The concept of the transactional countries is the targeting of a direct tax base erosion (e.g. in Spain) and sometimes even the indirect tax base erosion (e.g. in Denmark, Germany).

10.6.3. The rules related to base company activities are partly different. Here, the *circumstances* for the provision of the services are decisive and not the *type* of services. That means, even non-capital intensive activities are subject to CFC taxation if - for example - the services are provided towards the resident shareholder or with the involvement of the resident shareholder. However, the economic result of the supply of non-capital intensive services may consist to a large extent of income which is related to the economic output created by personnel and not, as is the case for capital intensive services of the aforementioned types, of income which is largely related to the investment of capital, i.e. interest components, amortisation of the investment and the risk related to the investment. In principle, this is equally true for

Germany, Spain and Lithuania. The Danish approach is a bit different from the other transactional countries since it is strongly connected to financial income without having separate base company rules.

10.6.4. The entity approach goes even further and covers not only the situations which lead to tainted income and base company income under a transactional approach, but also covers the income related to an active business which is exercised by the CFC as a minor activity ("all-or-nothing" approach). An activity-based exemption from CFC taxation typically requires that the foreign company carries on mainly an industrial or commercial activity *and* mainly on the local market. Of course, this excludes most of the inter-company services which are normally directed towards the country of the shareholder and the countries in which other group companies are established. The entity approach is therefore - similar to the base company activities - completely unconnected to the question of capital intensive or non-capital intensive services. The entity approach is the predominant system of CFC taxation and all of the countries which follow an entity approach have - in one way or another - such a link to the activity of the foreign entity.

10.6.5. The requirement of low-taxation is a common feature in *all* of the European countries with a typical "*pre-Cadbury Schweppes*" CFC regime - no matter whether they follow a transactional or an entity approach. From the perspective of these countries, the current taxation of CFC income seems to be necessary only in cases where the effective foreign tax rate is below a certain threshold and the income is therefore considered to be low-taxed. If the income is subject to a taxation which is comparable to the domestic taxation or even higher than the domestic taxation, an immediate income allocation to the resident shareholder will not take place. Furthermore, it is important to note that the determination of the effective foreign tax rate is usually based on a taxable income which is adjusted according to the domestic tax rules. Overall, the low-tax requirement ranges from less than 1/1 of the domestic corporate income tax rate (like in Germany) to less than 1/2 of the domestic corporate income tax which would theoretically be applied on that income (like in France). The remaining countries are in-between these two fractions.

10.6.6. Another basic requirement for the application of CFC rules is the ownership in the CFC: in order to attribute the CFC income to a resident taxpayer, a certain - direct or indirect - shareholding is required. It is important to recognise that "control" in the sense that a resident shareholder or a group of related shareholders own *more* than 50 percent in the CFC is in most cases not required. A strict "more than 50 percent" requirement exists in Lithuania, where the resident entity (or individual) together with *related* parties has to hold - directly or indirectly - more than 50 percent. That means, in nearly all of the countries there is either a lower threshold or other - alternative - criteria exist which can trigger the application of the CFC rules. The examination of the ownership requirements in the countries shows that often not even a "substantial" or "qualified" shareholding is required, either. The requirement of control often refers to a certain (minimum) percentage of related or *unrelated* resident shareholders. Hence, if a substantial percentage is held by totally unrelated resident shareholders, the minimum threshold for the individual shareholder is extremely low, e.g. 5 percent in France if 50 percent of the share capital of the foreign company is directly or indirectly held by French residents, or 10 percent in Finland if at least 50 percent are held by Finnish residents. A drastic example in this respect is Germany: if the CFC exclusively or almost exclusively derives gross revenues of a capital investment kind, the tainted income will be allocated to the resident shareholder without applying any minimum threshold. This gives the impression that the influence of the shareholder is in fact secondary, and the main focus is on the current taxation of CFC income as an anti-deferral measure in order to avoid any tax base erosion instead of a clear limitation of the CFC regimes to majority shareholdings.

10.6.7. The domestic concepts of income attribution range from a deemed dividend approach (e.g. in Germany) and a look-through (or “piercing the veil”) approach (e.g. in Estonia, Italy, Portugal, the United Kingdom and Sweden) to a re-valuation of the shares in the CFC (the latter system exists in the Netherlands which, however, does not have a CFC regime in the narrower sense). Some Member States have a regime which might be seen as a look-through approach, but which is not completely clear in this respect (e.g. in Denmark and Spain). However, none of these concepts is fully convincing since the attributed income by no means reflects the result based on the commercial accounts of the CFC. This is due to the different CFC approaches (transactional approach and entity approach) and the fact that the attributable income is in most cases calculated pursuant to the domestic rules of the country which applies its CFC taxation. In fact, the income attribution according to the transactional approach can rather be seen as a system which solely and directly focuses on the separate income elements derived by the CFC from the perspective of the state of residence of the shareholder but - at the same time - completely ignores the income determination of the foreign legal entity. In contrast, the entity approach takes into account all income elements (active and passive) or none of the income elements, depending upon whether the active or the passive activity prevails. However, even the entity approach does not reflect the actual income based on the commercial accounts of the CFC but only the income which is based on the income determination rules of the state of residence of the shareholder.

10.6.8. The taxation based on the income attribution according to CFC rules and the taxation of subsequent dividends and subsequent disposal of shares can lead - at least partly - to a double taxation of income. It is therefore necessary for the CFC regimes to provide for some sort of relief from double taxation in these cases. This can be done by way of an adjustment of the tax base or a tax credit of the income tax levied on the former CFC income attribution against the taxes imposed on the dividend payments and the capital gains. Interestingly, the relief from double taxation caused by a subsequent dividend payment is provided by all of the regimes in one way or another (usually by adjustment of the tax base - with the exception of the United Kingdom which provides for a tax credit). In contrast thereto, the relief from double taxation caused by the disposal of the shares in the CFC is only granted in very few countries, namely in Denmark, Germany, Spain and the United Kingdom. It is quite apparent that there is no justification for a different treatment of dividends and capital gains since both transactions contain, in principle, the same profit elements and both transactions can lead to a double taxation of income. In addition, the test to the principles derived from previous chapters shows that - in order to avoid any penalty effects for the investor - the relief from double taxation cannot be restricted by CFC specific time limits - like in Finland and Germany - which can make the elimination of double taxation considerably more difficult or even impossible (e.g. in case of tax losses). Moreover, a double taxation of income can be caused by withholding taxes levied on the subsequent dividends. In this case, the withholding taxes should - retroactively - be credited against the income taxes imposed on the attributed CFC income if the actual dividend payment is exempt from taxation. Similar problems can arise if a double taxation of income is avoided by a tax credit of the former CFC income tax burden against the subsequent dividend income tax burden. Here, the problem lies in the fact that an ordinary tax credit system will often not provide for sufficient relief from double taxation (this can be true for income taxes and withholding taxes).

10.6.9. The treatment of losses in the context of CFC taxation is inconsistent and asymmetric and goes much further than is really necessary from an anti-avoidance point of view. One of the main aspects is the fact that positive CFC income is treated differently from negative CFC income. Often, the positive CFC income is taxed by the residence state of the shareholder in the same manner as domestic income derived by the shareholder. In contrast, negative CFC income can usually not be offset with positive domestic income of the shareholder but can only be carried forward and offset with positive CFC income of the same foreign legal entity in subsequent periods. It seems the latter is true for all of the European CFC regimes outlined in this chapter. In other words, the utilisation of negative CFC income is extremely restricted. However, the reverse situation is equally problematic, i.e. if positive CFC income is attributed to the resident shareholder who suffers domestic tax losses or has a domestic tax loss carry forward available. The examination revealed several problematic aspects, especially where the CFC regimes apply specific time limits for subsequent dividend payments and the disposal of shares, and time limits for the carry forward of negative domestic income and (or) negative CFC income. From my perspective, there is not a single European CFC regime which provides for an acceptable treatment of negative CFC income. It shows clearly, in my opinion, that the Member States which apply CFC rules are obviously willing to give away a symmetric concept of (international) taxation of income in favour of a strict domestic anti-deferral policy. The price for such an approach is the violation of basic freedoms - which will be outlined later on. An alternative concept which does not provide for an unequal treatment of domestic and international income is therefore necessary.

10.6.10. The examination shows that the CFC regimes have to provide for the crediting of taxes imposed on the underlying CFC income. However, an appropriate relief from double taxation requires that the crediting does not only encompass the corporate income tax in the CFC country but also any other income tax levied in third countries (e.g. in case of a permanent establishment) and the withholding taxes deducted from the respective income elements, e.g. royalty income, interest income. The deduction of taxes as a kind of business expenses is not sufficient and leads to a partial double taxation of income. The possibility for a crediting of the income taxes imposed in the CFC country exists in almost all of the Member States which apply such regimes. An exception, for example, is Hungary where no such indirect tax credit exists. The crediting of taxes imposed in third countries is provided for by a number of countries, e.g. Denmark, Finland, Germany, Italy, Spain, Sweden and the United Kingdom.

10.6.11. Another very important aspect is the fact that CFC regimes most often do not sufficiently provide for the multiple application of CFC taxation and similar anti-avoidance rules, i.e. in situations where comparable legislation is applicable on a lower group level. The examination shows various problems which can arise in such a situation. One of the main aspects is certainly the question of an appropriate tax credit system. In order to solve the double taxation conflicts caused by the current taxation of income the regime must provide for a tax credit system which takes into account the taxation on a lower group level and which does not strictly focus on a particular taxation period. That means, taxes imposed on the underlying income at a later point in time on a lower group level cannot be outside of the scope of the tax credit system. Otherwise, and this is very often the case, the CFC regime leads to an immense over-taxation of income. Moreover, substantial conflicts can arise, *inter alia*, in cases where tax losses are involved, where limitations exist with respect to tax losses and time limits for subsequent profit distributions and capital gains, where the income is determined pursuant to the domestic tax rules of the country which applies the CFC taxation, where the income is taxed on a intermediate level according to the credit method, and in case of classification conflicts. Thus, the application of CFC rules in a multiple tier structure can create problems which may only partially be solved by - for example - an extended ordinary credit system. Other double taxation conflicts may only be solved by mutual agreement procedures among the countries involved. In other words, the multiple tier structures can considerably increase the already existing double taxation conflicts caused by the application of CFC rules. Currently, only Finland and Germany provide for a systematic (ordinary) crediting of the taxes imposed according to a lower tier CFC taxation. Other regimes either ignore these types of double taxation, rely on mutual agreement procedures (like in France), or take the additional (higher) taxation into account for the question of a motive exemption (like in the United Kingdom). However, the problem is that even the two countries which have a system in place for dealing with such a multiple CFC taxation do not provide for more than the simple ordinary tax crediting. That means Finland and Germany do not really solve the other problems which may come in a multiple tier structure.

10.6.12. Mutual agreement procedures as well as any other solutions which are not based on a clear legislative and systematic concept are not, in my opinion, the appropriate way of solving the problem of double taxation of income in the context of CFC taxation. As already outlined above, what is required is an alternative concept to CFC rules which provides for a consistent taxation of domestic and foreign income. In my opinion, this can be achieved by a system which accepts the taxation of income in the state in which it is produced - and which therefore, in general, follows the principle of capital import neutrality - but without ignoring the necessity of an anti-deferral taxation for part of the income under certain circumstances.

10.6.13. An alternative concept should follow the principles outlined above by providing a systematic and symmetrical system of current taxation, i.e. a system which is safeguarding competitiveness without creating any penalty effects for an investor. In essence, this would result in a deviation from the typical CFC regime towards a regime which limits the current taxation of income to the basic interest component and which therefore provides for a horizontal and vertical separation of income (instead of a merely horizontal separation of income). In any event, the economic principles and equity aspects clearly support, in my opinion, such a limited taxation according to the principle of capital export neutrality. However, neither a CFC regime nor an alternative approach should lead to an over-taxation of income and, therefore, have to provide for a consistent relief from any sort of double taxation caused by the current taxation of income.

10.7. CFC Legislation and Double Tax Conventions

10.7.1. Up to now only a few tax courts in Europe have dealt with the question of compatibility of double tax conventions and CFC legislation. However, with the exception of the French *Schneider* Case, the case law which has been examined did not see a conflict between double tax conventions and the application of CFC rules, even if the latter rules are not explicitly preserved in the respective conventions. In the *Schneider* Case, the French Supreme Tax Court concluded that the CFC rules cannot be applied if the application is not expressly confirmed in the French tax treaties. In contrast, the Finnish Supreme Tax Court did not see any conflict in the *A Oyj Abp* Case between the application of the Finnish CFC regime and the Finland-Belgium tax treaty which does not contain any specific provision in this respect. The same is basically true for the decision in the British *Bricom Holdings* Case where the Court of Appeal did not see any restriction for the application of the United Kingdom CFC regime to income derived by a legal entity resident in the Netherlands. The Swedish Council for Advance Tax Rulings decided in two cases - which dealt with captive insurance companies in Luxembourg and Switzerland - that the application of the Swedish CFC regime is not in conflict with the respective tax treaties. Also in the Swedish cases, the double tax convention did not explicitly deal with the applicability of CFC rules.

10.7.2. The position of the OECD is now made clear since the 2003 update of the Commentary. Before the 2003 update, the Commentary solely provided the majority and minority opinions of the Member countries. Pursuant to the OECD, the CFC rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to tax liabilities. These rules are not addressed in tax treaties and are therefore not affected by them. Thus, the OECD does not see, in principle, a conflict between tax treaties and domestic CFC legislation. I agree with the position that CFC rules do not have to be specifically preserved in a double tax convention. Those rules do not have to be treated differently from any other domestic legislation which can be of relevance in the relationship between the respective tax treaty countries. It is not the CFC, i.e. the foreign company, which is taxed in the residence state of the shareholder, but the shareholder is taxed on income derived through the interposition of the CFC. Thus, there are two different taxpayers involved and the tax treaty does not prevent the taxation of the shareholder in the state of residence on income derived through the CFC. In contrast thereto, the CFC itself may only be taxed in the residence state of the shareholder in case of a permanent establishment of the CFC in the latter state.

10.7.3. Furthermore, the OECD takes the position that CFC rules should only be applied to certain passive activities but not to active businesses. As already outlined earlier a separation between “active” and “passive” can be quite difficult. In any case, the OECD considers “base company activities” to be passive activities. In my opinion, this may have the effect that income from business activities is subject to CFC taxation.

10.7.4. Thus, the existing CFC rules are in most cases too broad for a separation of abusive and non-abusive activities, i.e. CFC rules target both, the abusive and the non-abusive relocation of activities to low-tax countries. Therefore, even if the general aim of a double tax convention encompasses, *inter alia*, the combating of international tax avoidance and tax evasion, this must not result in an unrestricted application of CFC rules *outside* the limitations provided by a double tax convention. That means, if the residence state of the shareholder stipulates, in the context of the domestic CFC legislation, a link to the income which is derived by the shareholder through a CFC interposed in the other contracting state, it is required to examine the latter income and to determine the type of income in the light of the respective tax treaty - from the perspective of the residence state of the shareholder. Hence, if the income classification leads to the outcome that the state of residence of the shareholder has the right to tax the income of the shareholder under the respective tax treaty, there is, in principle, no restriction for the application of the domestic CFC legislation. In contrast thereto, if the income classification leads to the outcome that the state of residence of the shareholder does not have the right to tax the income of the shareholder under the respective tax treaty, the application of the domestic CFC legislation will result in a tax treaty override.

10.7.5. The CFC income has to be categorised in the context of the tax treaty. In my opinion, it is the actual activity carried on by the CFC which has to be examined and which should be the basis for the income qualification of the residence state of the shareholder (the state which applies the CFC legislation). Since the OECD-MTC does not provide for an exhaustive definition of the term "business profits", the domestic definition of the state which applies its CFC rules has to be referred to. If it turns out that the income derived from these activities (e.g. service activities) is to be qualified - from the perspective of the state which applies its CFC rules - as "business profits," the income which is allocable to the residence country of the shareholder may be taxed in the latter country pursuant to Article 7 (1) of the OECD-MTC. Thus, it is important to note that even though the activity carried on by the CFC is to be examined, the qualification is to be made, in my opinion, from the perspective of the state which applies the CFC rules.

10.7.6. The residence state of the CFC, of course, has to make its own qualification of the income derived by the CFC (in contrast to the aforementioned qualification of the income derived by the shareholder through the interposition of the CFC). The approach of the residence state of the CFC, however, is of no relevance, in my opinion, for the qualification of income under the CFC regime in the state of the shareholder. Thus, there are two different states involved which examine the income of two different taxpayers. The qualification of the respective income as "business profits" does therefore not result in a conflict under the respective tax treaty.

10.7.7. It is often suggested that the CFC income is to be qualified - as a whole and in general - as dividend income in the context of the OECD-MTC. One of the main arguments for the qualification as dividend income is the inseparable link between the holding of shares in the foreign legal entity and the CFC income attribution. Furthermore, the definition of the term "dividends" in Article 10 (3) of the OECD-MTC requires an autonomous examination in the context of the tax treaty. Dividends means "*income from shares*" and it seems that the definition also encompasses hidden distributions of profit without any actual outflow of financial means to the shareholder. In my opinion, those arguments do not necessarily require a qualification as dividends (or a deemed dividend) and there are a number of aspects which do not support such a qualification:

- In nearly all countries which apply such legislation, the CFC income is determined according to domestic rules. The income of the foreign legal entity which may be distributed to the shareholder is therefore typically different from (and unconnected to) the attributed CFC income.

- The CFC rules focus on certain types of income and ignore the actual income based on the commercial accounts of the foreign entity. This is particularly true for the transactional approach.

- Although the likelihood that the CFC rules cover the same types of income as the foreign legal entity is higher in case of an entity approach, it is by no means clear that this is the case for a period of more than one year. The (partial) change of activities can lead to the result that the income is subject to CFC taxation in one year but not in another.

- The attribution of CFC income has no influence on the income based on the commercial accounts of the foreign company and it has no influence on the net asset value (in contrast to open or hidden distributions of profit). The company is therefore in a position to distribute all of the profits derived from its activities to the shareholder and this is - and must be - totally unconnected to a CFC income attribution.

- The actual profit distribution of the company leads to income from shares (dividend income) and reflects the added value of the investment. It is by no means comparable to the CFC income attribution - even though they are economically related to the same income.

- It follows from the features and the mechanism of CFC rules that the concept of CFC income attribution is different to the concept of dividend income. The focus on the residence state of the foreign entity and the fact that the term dividend means "*a distribution of profits to the shareholders*" requires - in my opinion - a nexus between the income based on the commercial accounts of the company and the (open or hidden) distributions to the shareholder. It is the (net) profit of the company which is made available to the shareholder by way of profit distribution. In contrast, the CFC rules are very specific and only attribute the income in certain limited and clearly defined situations. This can have the effect that the CFC taxation is not applicable during the entire period of foreign investment but only in years where certain requirements are fulfilled. The application typically requires that (i) a certain participation threshold is exceeded, (ii) a certain low-taxation threshold is *not* exceeded, and (iii) certain income elements are derived by the foreign entity (transactional approach) or a certain mixture of income and / or certain circumstances are existent (entity approach).

10.7.8. The question arises whether the CFC income can still be qualified as "business profits" in case the attributable income also encompasses elements of interest income, royalty income or dividend income. In my opinion, the following separation has to be made:

- If, from the perspective of the state which applies the CFC rules, the income derived by the shareholder through the CFC is to be qualified, in total, as "business profits" - despite the fact that also other elements like interest income, royalty income, and dividend income are included - there is no necessity for any subdivision of the business profits. In other words, it is decisive whether the elements included in the income can result in a different qualification of the respective activity and the respective income. If this is not the case, the whole income is to be qualified as business income. Here, the different elements become an integral part of the business activity and the business income. It can also be described, in my opinion, as an amalgamation of elements which might be, on a "stand-alone basis", separate types of income. The outcome of the qualification should not be dependent upon whether the resident shareholder in the CFC is an individual or a legal entity. The qualification should solely be made on the basis of the activity of the CFC and is therefore unrelated to the (legal) status of the resident shareholder. The domestic differentiation in the state of residence of the shareholder between income derived by individuals and income derived by legal entities has no influence on the qualification, because it is the activity of the CFC itself which should be relevant in this respect.

- The residence state of the CFC has to make its own qualification of the income derived by the CFC. Here, the residence state of the CFC has to take into account the different types of income for the allocation of taxing rights under the double tax conventions concluded by the latter state (e.g. with respect to withholding taxes) - even though the different income elements may finally also become an integral part of the business income of the CFC from the perspective of the residence state of the CFC (similar to the approach which was outlined above with respect to the residence state of the shareholder).

- If the activity carried on by the CFC is solely limited to a passive activity, such as the deriving of interest income (or dividend / royalty income), and the activity itself does not contain any substantial service element (or any other substantial element of a business activity), the reference to the domestic law of the residence state of the shareholder (the state which applies the CFC rules) might lead to the outcome that the income is to be determined as interest income (or dividend / royalty income) and not as business income. The definition of "interest" included in Article 11 (3) of the OECD-MTC is of no importance in this respect. The latter is only relevant in the context of Article 11 of the OECD-MTC for the allocation of taxing rights related to the gross amount of interest payment (withholding taxation) between the country of source and the country of residence of the CFC (and not the shareholder). Based on the domestic definition of the residence state of the shareholder, the CFC income may be qualified as interest income (dividend / royalty income) for tax treaty purposes. This would also lead to a taxation of the CFC income in the residence state of the shareholder. The different qualification does not restrict the right to tax the income in the country of the shareholder which applies its CFC taxation. This is not only true for interest income but also for dividend income and royalty income.

- The income from immovable property is not equally flexible and subject to disposal of the shareholder, and therefore less often subject to CFC taxation compared to the aforementioned types of passive income, but this does not mean that this type of income is completely outside of the scope of CFC taxation. However, there is a major difference between interest income, royalty income and dividend income on the one hand and income from immovable property on the other: the concept of Article 6 of the OECD-MTC requires a source based taxation of the rental income and is by no means limited to a withholding taxation of the gross amount of income. The taxation is therefore based on a net concept. However, this should not lead to the outcome that the income from immovable property is treated differently from the other types of income outlined above. The CFC rules do not tax the direct owner of the immovable property but the (direct or indirect) shareholder in the company which carries on the rental activities. The classification of income is therefore to be made separately for two different persons by two different states. Hence, Article 6 of the OECD-MTC does not directly restrict the taxing rights of the state of the shareholder. For this reason, a limitation of taxing rights which follows the concept of Article 6 of the OECD-MTC could only be made by analogy. In my opinion, the only justification for such an analogous application might be derived from the concept of a strict source-based taxation of the net income from immovable property, i.e. if both contracting states follow a strict source-based taxation of rental income - not only in relation to each other but also in relation to third states - and the double taxation is avoided solely by the application of the exemption method. In such a situation, it is not only questionable whether a CFC taxation of rental income is actually required from an anti-avoidance perspective, but one might also argue that the application of those rules is in contradiction to the purpose and the idea of the respective tax treaty. However, the OECD-MTC does not provide for an analogous application of Article 6 and I do not see, therefore, any legal basis for such an approach. That means, even the classification of the attributed income as rental income - from the perspective of the residence state of the shareholder - would not restrict the right to tax the attributed income.

10.7.9. The principles are equally relevant for the taxation of capital gains under a CFC regime: if the activity is to be qualified as business activity, the capital gains are part of the allocable business income. In all other cases, the qualification is to be made with reference to the domestic legislation of the country which invokes the respective double tax convention. The wording "*shall be taxable only*" in Article 13 (5) of the OECD-MTC is no obstacle for the taxation of CFC income, because there are two different taxpayers involved.

10.7.10. Based on the argumentation above, there is not much room for the application of Article 21 of the OECD-MTC. However, even if one takes the position that the CFC income attribution falls within the scope of Article 21 of the OECD-MTC, the outcome would not be different. The taxing rights related to other income are allocable to the residence state of the shareholder which applies its CFC taxation.

10.7.11. In my opinion, the qualification of income should not be dependent upon the respective CFC system (entity approach or transactional approach). The domestic methodology of creating a nexus to the income of the CFC and the limitation to certain types of income cannot be of any influence for the qualification of income under the respective tax treaty. If the income has to be qualified pursuant to the actual activity carried out in the CFC country (e.g. business activity), any limitation of the income attribution to a certain part of the net income, e.g. interest income under a transactional system, should not lead to a qualification of the attributable income as interest income instead of business income. Otherwise, it would be the domestic structure of the CFC legislation which is solely decisive for the qualification of the attributed CFC income by the mere fact that it refers to certain income components which are indirectly included in the net income.

10.7.12. In principle, the general application of CFC rules to all types of income instead of a limitation to certain types of income and / or certain circumstances might lead to a circumvention of tax treaties. At least, this might be true in cases where the respective tax treaty otherwise provides for the exemption of dividend income and the income from capital gains on the disposal of shares, and where the application of the CFC regime results in a complete and unrestricted taxation of the whole CFC income. On the other hand, it should not be overlooked that in case of a credit country the main consequence is the immediate taxation of CFC income and the avoidance of tax deferral. The business profits derived by the foreign legal entity are still taxable in the source country and as long as the country which applies the CFC rules provides for a crediting of the foreign income tax an international economic double taxation would be avoided.

10.7.13. The conclusions are equally relevant for an alternative regime which is based on the economic and equity principles described earlier, i.e. a regime which focuses on the taxation of the basic interest component. The latter approach does not result in a juridical double taxation - just like the regular CFC regimes. In other words, the basic interest approach would be in line with double tax conventions if the scope of such conventions is not explicitly extended to international economic double taxation.

10.8. CFC Legislation and European Union Law

10.8.1. The primary EU law has a significant influence on the CFC regimes of the Member States. The investment in companies which trigger the application of CFC rules may be in the scope of the freedom of establishment and / or the free movement of capital. Theoretically, the activities of the CFC might also be - depending on the facts and circumstances of the case - in the scope of the freedom to provide services.

10.8.2. In order to come within the scope of the freedom of establishment the CFC must pursue a genuine economic activity through a fixed establishment in another Member State for an indefinite period. The mere holding of assets cannot be considered an economic activity, but a certain (minimum) economic output is required in the host Member State. In principle, the mobile activities which were described in previous chapters are also covered by the freedom of establishment as long as the aforementioned requirements are fulfilled. In essence, the investment in a CFC is not to be seen differently from any other investment in a foreign company.

10.8.3. In the *Cadbury Schweppes* case, the first case dealing with CFC legislation, the ECJ made it clear - based on settled case law - that an activity cannot be considered a wholly artificial arrangement if the CFC is genuinely established in the host Member State and has the premises, staff and equipment necessary to carry out the services.

10.8.4. The examination shows that the freedom of establishment and / or the free movement of capital prevail over the freedom to provide services. This is not only true in cases where the services of the CFC are directed towards the shareholder in the CFC, but also in cases where the services are provided to a recipient in another state who does not have any investment in the CFC. The freedom to provide services is therefore of no particular relevance in the context of this study.

10.8.5. The free movement of capital plays a less important role in the case law of the ECJ than it could be expected from its very broad scope of application. The reason is that - based on the case law of the ECJ - there are important situations where the freedom of establishment prevails over the free movement of capital. The following differentiation can be made:

A. (Part of) CFC legislation which requires definite influence over the decisions of the CFC	the following basic freedoms are affected:
a.) CFC in another Member State	Article 49 TFEU
b.) CFC in a non-member state	---
B. (Part of) CFC legislation which does not require definite influence over the decisions of the CFC (e.g. FIF type legislation)	the following basic freedoms are affected:
a.) CFC in another Member State	
aa.) definite influence (actually)	Article 49 TFEU
ab.) no definite influence (actually)	Article 63 TFEU
b.) CFC in a non-member state	
ba.) definite influence (actually)	Article 63 TFEU (uncertain)
bb.) no definite influence (actually)	Article 63 TFEU

10.8.6. The question whether the CFC legislation can result in a restriction on the exercising of the aforementioned basic freedoms can be answered in the affirmative. In fact, there are a number of possible restrictions which can be caused by the application of CFC rules and which are dependent on the situation of the shareholder who is subject to CFC taxation. Most of the disadvantages were already identified in the case law of the ECJ as restrictions on one or more of the basic freedoms. The restrictions may range from liquidity and administrative disadvantages to a massive double taxation of income.

10.8.7. In order to identify a restriction which is caused by the application of CFC rules, it is important to determine the appropriate pair of comparison. The examination shows that the pair of comparison has to be limited to a mere vertical comparison and cannot be extended to a horizontal comparison.

10.8.8. The examination further shows that the theoretical acceptance of a horizontal comparison would not result in an obligation for the Member State of primary establishment to provide for a "most-favoured nation" treatment. Firstly, up to now the most favoured nation treatment has not been accepted by the ECJ and, secondly, the CFC rules are solely national legislation - and not tax treaty provisions - which do not provide any basis, in my opinion, for such a far-reaching obligation.

10.8.9. A number of possible arguments for the justification of a restriction on the exercising of the basic freedoms can come up in a CFC case. The following arguments were identified and examined in this context:

- the cohesion of the tax system;
- the loss of tax revenue and the erosion of the tax base;
- the lower taxation in the CFC country,
- the principle of territoriality;
- the protection of a balanced allocation of the power to impose taxes between Member States;
- the effectiveness of fiscal supervision;
- the aim of preventing tax avoidance;
- the principle of world-wide taxation.

10.8.10. The examination shows that the above arguments cannot be accepted as a valid justification in a CFC case. Given the fact that the CFC regimes are usually structured as anti-avoidance (anti-deferral) legislation, the aim of preventing tax avoidance is certainly one of the most obvious arguments. However, it is clear from the *Cadbury Schweppes* case and previous decisions that such legislation must focus on wholly artificial arrangements. Clearly, this is not the case for the CFC regimes which were outlined in chapter 6 and which have not been amended after - and according to - the *Cadbury Schweppes* decision. These CFC regimes are applicable in an undifferentiated manner to different types of low-taxed income and are actually *intended* to be applicable to income derived from genuine economic activities. For this reason, the aforementioned CFC concepts will not be proportional as long as they do not provide the shareholder with the possibility of submitting evidence that the activity carried out in the other state is a genuine economic activity - and to be exempt from CFC taxation in such a situation. From my perspective, the outcome of the *Cadbury Schweppes* case is neither mitigated through the VAT case law of the ECJ nor the subsequent *Oy AA* decision. In VAT cases, the national court has to make an overall assessment and has to decide whether the tax motive is essential compared to the non-tax explanations (such as economic objectives). For this reason, the structure can be considered abusive from a VAT perspective despite the fact that economic objectives exist. In contrast thereto, if a CFC is genuinely established in another state, it does not play a role whether or not the saving of (income) taxes was the principal aim of the relocation. With respect to the Oy AA decision - a case dealing with a provision of the Finnish corporate income tax system - I have made it clear that, in my opinion, the fact that the ECJ accepted a system which was not specifically designed to target wholly artificial arrangements is only due to the fact that the justification was (also) based on the protection of a balanced allocation of the power to impose taxes between Member States. From my perspective, it was completely misleading to put forward the aim of preventing tax avoidance in a situation where another justification requires a much broader scope - and which may therefore also require an acceptance in case of genuine economic activities.

10.8.11. The requirement of giving the taxpayer the possibility of submitting evidence that the CFC carries out a genuine economic activity should be equally relevant for investments in non-member states. However, based on the case law of the ECJ, the Member States may require that a legal basis exists for information exchange between the competent tax authorities of the respective Member State and the non-member state where the investment was made, e.g. based on a double tax convention. Such an additional requirement is needed because of the fact that the Council Directive 77/799/EEC is not applicable in case of non-member states. An information exchange clause ensures, therefore, that the information provided by the taxpayer can be verified. Overall, there are some cases dealing with the latter aspect in relation to non-member states and it is obvious that the existence or non-existence of an information exchange clause may be decisive for the question whether a restriction can be justified or not. However, it is my understanding that the existence of an information exchange clause on a bilateral basis is to be taken into account as well and - depending on the situation - may have the same relevance for the ECJ as the Council Directive 77/799/EEC.

10.8.12. The CFC regimes can be directly and indirectly influenced by secondary EU law. A direct influence exists, in my opinion, in case of the Parent-Subsidiary Directive. The amended version of the latter Directive not only covers profit distributions but also the current taxation of income derived through a hybrid entity. In my opinion, it would be neither logical nor consistent to consider the CFC income attribution to be outside of the scope of the Parent-Subsidiary Directive. The Parent-Subsidiary Directive determines that either the exemption method or the credit method has to be applied for the elimination of double taxation. In case of a hybrid entity, the subsequent profit distribution - which was already subject to a current taxation of income - should be exempt from domestic taxation. In general, the latter mechanisms are already offered by almost all CFC regimes and I do not expect substantial changes which are based on the Parent-Subsidiary Directive. However, the Directive becomes an additional limitation for changing the structure of CFC regimes.

10.8.13. An indirect influence of secondary EU law exists in case of the Interest and Royalty Directive. The examination shows that the abolition of a limited source-based taxation (withholding taxation) may clearly support the structures which are typically in the focus of CFC regimes. The non-existence of a withholding tax credit (due to the fact that there is no withholding tax) on the level of an intermediate finance company may considerably improve the situation of the state where the latter company is established. Moreover, the abolition of a withholding taxation in the country where the income is produced is, despite all administrative simplifications, contrary to the economic and equity principles described in this study.

10.8.14. In my opinion, the case law of the ECJ results in a dilemma for those Member States which apply CFC regimes: either they provide an “escape clause” for genuine economic activities or the CFC regimes, in their current structure, will not be in line with the freedom of establishment and / or the free movement of capital. The examination in previous chapters shows that it is the intention of the CFC regimes to currently tax income derived from genuine economic activities and not necessarily from wholly artificial arrangements. The latter arrangements are usually covered by other anti-abuse measures. For this reason, I do not think that the implementation of an escape clause for genuine economic activities is an appropriate solution for a great number of these Member States.

10.8.15. In principle, it is understandable that Member States with a comparably high tax rate want to protect their tax revenues and want to stop the erosion of the domestic tax base in favour of low-tax countries and territories. However, it is equally clear that “tax competition” should be supported as long as it is sound competition among states which leads to an efficient allocation of resources. Such competition is clearly supported by the economic and equity principles outlined in chapters 2 and 3. However, this has to be separated from harmful competition which is triggered by countries and territories which have an over-proportional advantage from the inflow of capital and mobile investments to the detriment of other states. In the latter case, the state or territory which attracts the capital is usually merely an intermediate location and the income - based on the employment of such capital - is produced outside of this state or territory. The latter situation is not supported by the economic and equity principles outlined earlier and the Member State should have the possibility of applying legislation which - directly - targets the structures which result in such harmful competition. In my opinion, the taxation of the basic interest component of capital for certain mobile investments - without making a differentiation based on the place of investment - could be a very efficient approach without restricting sound competition.

10.8.16. The approaches of the Member States in order to comply with EU law and, in particular, the *Cadbury Schweppes* decision are different. This can be shown by the following country examples:

- Finland: the amended CFC regime provides an exemption from CFC taxation for entities which are established in an EEA state or a tax treaty state whose tax system does not differ substantially from the Finnish tax system, provided that an exchange of information is possible with the other state. In addition, it is required that the entity is actually established and carries on a genuine economic activity in the host state.

- France: the French CFC regime provides for an EU entity exemption to a shareholding in the foreign entity which does not constitute a wholly artificial arrangement intended to escape French tax. The notion of a wholly artificial arrangement must be assessed with regard to the objective criteria arising from the ECJ case law. The exception applies to participations held by French corporations, but not by French individual shareholders.

- Germany: the amended CFC regime grants an exemption from CFC taxation for EU/EEA state if the taxpayer can provide evidence that the CFC carries out a genuine economic activity in the host state. In addition, it is required that an appropriate procedure for collaboration and exchange of information is established between Germany and the other state. It remains unclear what is actually meant by genuine economic activity. Moreover, it is stated that only income which is derived through the activity of the CFC itself can be allocated to the genuine economic activity and only to the extent that the arm's length principle is taken into account.

- Italy: the CFC regime does not result in a current allocation of income if it can be demonstrated that the entity carries out an "effective business activity." However, it has to be noted that the latter activity is not necessarily the same as the "genuine economic activity" which was described in the *Cadbury Schweppes* decision. Moreover, the exemption from CFC taxation is completely dependent on a positive ruling of the Italian tax authorities.

- The United Kingdom: different proposals for an amendment of the CFC regime have been discussed. The proposals range from the rather innovative system of a deduction of the "net economic value" from the allocable amount of income (which essentially results in a vertical separation of income) to the switch from the exemption method to the transactional method and the application to resident and non-resident entities. A concrete proposal for a new CFC regime was published in June 2011 which, however, seems to be an amendment to the "CFC type" rules but not the introduction of an innovative system. In my view, it is more than questionable whether the proposed regime really restricts the application to wholly artificial arrangements.

- Denmark: the revised regime is now applicable to resident and non-resident entities without any link to the effective tax rate. The regime shall apply to participations of more than 50 percent and only to subsidiaries which derive more than 50 percent financial income and which have at least 10 percent financial assets. The undifferentiated and non-discriminatory approach does not provide an exemption for genuine economic activities carried out by the respective entity.

- Sweden: the new Swedish regime grants an exemption from CFC taxation if the foreign entity "constitutes an actual establishment from which activities conducted for business reasons are carried out." In this regard, several factors shall be taken into account for the assessment. According to the preparatory work of the revised legislation, the provision must not be interpreted as more far-reaching than what is allowed by the *Cadbury Schweppes* decision. The revised legislation will be relevant for establishments within the EEA.

10.8.17. From my perspective, the strict limitation of an exemption from CFC taxation to EU Member States and EEA States should not be acceptable from an EU law perspective. Depending on the situation, the free movement of capital may require an unrestricted access to non-member states. Of course, the requirements for investments in non-member states may partially deviate from those which are needed in case of investments in other Member States, e.g. with respect to the existence of an information exchange between the respective states, but this cannot lead to the outcome that an exemption from CFC taxation, for example based on the existence of a genuine economic activity, is - in general - not granted to the shareholder (i.e. even if the additional requirements are fulfilled).

10.8.18. The examination shows that the principle of capital import neutrality fits the idea and the concept of an internal market much better than the principle of capital export neutrality. The Member State which provides the benefits for the income production should have the right to tax the “fruits” of the activities. If it is a Member State with a low level of taxation, it will be rewarded for its improvement of the overall efficiency. Otherwise, i.e. if the Member State with the low level of taxation does not receive the sole right to tax the income, this might seriously distort the capital investments among Member States with the effect of hampering (sound) tax competition. Any protectionist approach followed by the Member State of primary establishment, e.g. through the undifferentiated application of CFC rules, would hamper the overall improvement of efficiency.

10.8.19. However, the (theoretical) preference for the principle of capital import neutrality is one thing, the existing legal environment in the light of the OECD-MTC another. Thus, as long as the residence-based taxation is the prevailing system for income from capital intensive mobile activities, there is still the possibility of shifting income from the latter activities to intermediate companies in low-tax states - with the effect that the right to tax the total amount of income is also shifted to the latter states. This, however, is neither in line with the conclusions drawn in this study nor with the idea and the concept of an internal market.

10.8.20. In my opinion, the conclusions clearly support, in my opinion, the concept of a “limited” capital export neutrality approach, i.e. an approach which focuses on the current taxation of the basic interest component. It seems to me that this is the only possibility of bringing together the essential elements of an internal market with the previous conclusions and the needs of Member States for an acceptable anti-avoidance (anti-deferral) regime.

10.9. Alternative to the Existing CFC and FIF Legislation

10.9.1. The idea and the concept of an internal market do not, in general, preclude the limited application of the principle of capital export neutrality by taxing the basic interest component on a current basis.

10.9.2. The residence-based taxation of the basic interest component in the state of an intermediate service company can have a “clustering effect” in favour of low-tax states. That means the positive tax effect can attract equity investments in low-tax states which will subsequently, on the level of the service company, be transformed into capital services, i.e. a switch from equity investments to all types of capital services in order to take advantage of the allocation of taxing rights under double tax conventions which follow the pattern of the OECD-MTC. The current taxation of the basic interest component - and therefore the limited application of the principle of capital export neutrality - can target the “clustering effect” and can therefore support an efficient allocation of capital among states.

10.9.3. The taxation of the basic interest component requires a *vertical* and *horizontal* separation of income components instead of a merely *horizontal* separation of income. The latter approach of a horizontal separation is the typical approach under the existing CFC regimes.

10.9.4. The vertical separation of income components seems to be particularly interesting from an anti-avoidance perspective, because not all of the income components are equally relevant in this respect. Therefore, I propose the separation into three different components:

- income related to an activity physically conducted in the state of the service company (*activity component*);
- income related to the compensation of risks which are related to the capital investment (*risk component*);
- income related to the basic interest component of capital (*basic interest component*).

10.9.5. The *activity component* should be taxed strictly according to the principle of capital import neutrality and should therefore be subject to income taxation in the state where the income is actually produced. If this is the residence state of the service company, it should be subject to income taxation in the latter state only. The income should not be subject to any current taxation in the hands of the shareholder.

10.9.6. The *risk component* should be taxed in the state where the income is produced, too. However, most often the risk component is allocated - based on the underlying double tax convention - to the residence state of the service company which provides the capital (e.g. in the form of loan agreements, licensing agreements, leasing agreements, and similar agreements). In this case, the risk component is a compensation for the increased risks involved in the capital investment and the taking over of these risks. Any current taxation of this income component would take away part of the risk coverage in the state of the service company. Theoretically, this makes it necessary that the negative income - caused by the realisation of these risks - is taken into account in the state of the shareholder in the same way in order to avoid any asymmetrical taxation of income. In my opinion, a consistent approach would require the immediate offsetting of this negative income with other - positive - income of the shareholder. The net result related to the risk component is therefore difficult to predict, at least over a longer period of time, and seems to me less attractive for any tax based relocation. From the perspective of the Member States which apply the anti-avoidance regime, the uncertainties related to this particular income component reduce the effect of a current income allocation and make the system less efficient. Overall, the conclusion in such a non-optimal scenario of a taxation of the risk component in the residence state of the service company is to exclude the latter component from any current taxation in the hands of the shareholder.

10.9.7. The *basic interest component* is, in the same way as the other two components, an income element which should be taxed, in general, in the state where the income is produced. However, the allocation of the taxing rights to the residence state of the service company - based on double tax conventions - leads to the result that the basic interest component is neither taxed on the level of the company which produces the income nor in the state where the income is produced - at least in those cases where the state of residence of the service company is different from the state where the service recipient carries on the income-producing activity. In contrast to the activity component, the basic interest component can quite easily - and without any serious obstacles - be relocated from one state to another and to the place where the income taxation is most favourable. It is therefore by far the most flexible and mobile component. In contrast to the risk component, the basic interest component is not a compensation for the risk coverage and the taking over of risks. It is just the basic interest element which is related to the capital investment and can therefore be taxed, theoretically, and in the absence of the taxation in the state of income production, in the residence state of the service company as well as in the residence state of the shareholder. The current taxation of the basic interest component is therefore, in my opinion, an efficient tool in order to target the erosion of the tax base which is related to this particular income element.

10.9.8. Such an anti-avoidance approach is supported by transfer pricing principles (e.g. the OECD transfer pricing guidelines), but it is obvious that the transfer pricing principles cannot be seen as a substitute for an anti-avoidance legislation which focuses on the current taxation of income.

10.9.9. An alternative anti-avoidance legislation which is based on the current taxation of the basic interest component has to take into account a number of aspects, especially the following:

- The legislation must be applicable in a non-discriminatory manner to income generated by resident and non-resident entities in order to be in line with EU law.

- The determination of “tainted activities” in order to limit the application to capital services which entail an increased risk of tax avoidance. This reduces the scope of application to the activities in which the basic interest component plays an important role and reduces, at the same time, the administrative burden which may be caused by such legislation. The tainted activities should encompass financing activities, licensing activities, leasing and renting activities related to movable and immovable property, and any other activities which are related to the provision of capital which is utilised not by the company itself but by another party and which includes a financing element.

- The separation of the basic interest component from the total amount of income derived from the activities is quite complex and difficult. A simpler and more practical approach is the determination of a percentage which can be applied on the capital invested in tainted property. The benchmark for the determination of the basic interest component might be derived from the yield of high quality state bonds, inter-bank rates (e.g. Euribor) or European Central Bank basic rates. In my opinion, a compromise is required to bring together the requirements based on economic and equity principles and the anti-avoidance aspects. Such a compromise can be the determination of a rate which is applicable for the whole year instead of a rate which is adjusted regularly. Of course, such a rate will also include expectations, e.g. with respect to the development of the interest and inflation rate. From my perspective, the 12 months Euribor which is determined, as an average, for the month preceding the financial year for which the rate should be applicable can be an appropriate benchmark.

- The risk component is to be excluded from the current income taxation - as outlined above - if it can reasonably be assured that the system may not be circumvented or otherwise significantly manipulated to the detriment of the Member State which applies such legislation. Normally, this is not the case, but it may depend on the legislative framework of the Member State which applies such legislation. If necessary, the latter Member State has to amend its legislation in this respect.

- A consistent approach makes it necessary, in my opinion, that such legislation is not only applied to the direct shareholder in the company which carries on the tainted activities, but also to the ultimate resident - direct or indirect - shareholder. This can be an individual shareholder, a permanent establishment of a non-resident shareholder, or a corporate shareholder.

- The question has to be answered whether the alternative anti-avoidance legislation should only be applied to non-transparent entities or whether it should also be applied to transparent entities and permanent establishments. The reason is that the application of the exemption method for income derived by foreign transparent entities and permanent establishments can have an effect which comes close to the sheltering of income. However, the extension of the legislation to non-transparent entities and permanent establishments - with the consequence of a switch from the exemption method to the credit method - may result in a tax treaty override which, of course, has to be avoided. From an anti-avoidance perspective, the problem is reduced by the fact that the alternative legislation is also applied to indirect shareholdings - and therefore to the individual or corporate taxpayer behind the company which has a permanent establishment - and by the fact that the allocation of tainted activities to a transparent entity or permanent establishment is more difficult than in case of a non-transparent entity which is to be considered a separate legal entity.

- The alternative legislation should not be applied to each and every resident shareholder. A certain minimum threshold is necessary to ensure that the shareholder has sufficient influence on the activities of the respective company and to gather the information required for the current taxation of income. Here, it is important to find an appropriate balance between the necessity of an anti-avoidance legislation and the administrative burdens for the taxpayer. The percentage which was identified as an appropriate threshold is 25 percent. The threshold should be linked to the percentage of shareholding and the percentage of voting rights. Thus, if either the percentage of shareholding or the percentage of voting rights is reached or exceeded, the legislation should be applicable. The legislation does not require, in my opinion, an additional "absolute" financial threshold. In this respect, exemption provisions for minor investments can be provided.

- There is a need to define the persons who have to be classified as ‘related parties’ to the shareholder. In my opinion, the following persons have to be within in this category: (i) persons who are related through family membership, (ii) persons who are related through factual or contractual arrangements and (iii) persons who are related through shareholding structures.

- The stipulation of a minimum threshold makes it necessary to implement constructive ownership rules in order to avoid that the minimum percentage of shareholding or voting rights is circumvented.

10.9.10. Therefore, based on the conclusions drawn in this study, I propose an anti-avoidance legislation which is based on the current taxation of the basic interest component. The main elements can be summarised as follows:

- The proposed concept shall be named “capital service company legislation” or “CSC legislation” since it is applied to capital service activities (tainted activities).

- The tainted activities are financing activities, licensing activities, leasing and renting activities related to movable and immovable property, and any other activities which are related to the provision of capital which is utilised not by the entity itself but by another party and which includes a financing element.

- The CSC legislation is applicable in a non-discriminatory manner to resident and non-resident entities which carry on tainted activities.

- The basic interest rate is to be derived from the 12 months Euribor which is determined, as an average, for the month preceding the financial year for which the basic interest rate should be applicable. This rate should be applicable for the whole financial year of the entity which carries on the tainted activities.

- The basis for the calculation of the attributable income is, in general, the average book value of the tainted property in the balance sheet of the CSC (*calculation basis*). However, adjustments have to be made if the book value deviates from the average economic value - based on the expected economic lifetime of the property concerned. Adjustments are also required in case of extraordinary write-downs and similar measures as well as in case of contractual provisions which lead to an increase or a decrease in the average amount of capital provided during the contractual period. The underlying assumption is that the economic value reflects the amortisation in an agreement which is based on the arm’s length principle. The taxpayer has the possibility of providing the evidence that the value after amortisation is lower than the average economic value. The calculation basis does not necessarily reflect the fair market value of the respective property. What is important for the determination of the calculation basis is not a ‘mark-to-market’ value at specific points in time, but a value which reflects, as much as possible, the average amount of capital provided during the contractual period.

- In case the activities are (partly) debt-financed, the calculation basis has to be reduced. The percentage of equity-financed investments which are related to the tainted property has to be determined based on the ratio of the total average amount of equity to the total average amount of equity plus the total average amount of interest-bearing debts. The equity-percentage has to be applied to the calculation basis in order to end up with the *net calculation basis.*

- The CSC legislation is to be applied to direct and indirect participations in non-transparent legal entities and to permanent establishments of those entities as well as to the participations of the latter entities in transparent partnerships. The allocation of tainted and non-tainted property between the state of the headquarter company and the state of the PE (PS) follows the allocation which has to be made for income tax purposes.

- The CSC legislation applies to direct and indirect shareholdings of at least 25 percent (percentage of shareholding or, alternatively, percentage of voting rights). The requirement of a 25 percent threshold applies to the investment in the CSC itself, i.e. even in case of multiple-tier structures the shareholder is required to hold a participation of at least 25 percent in the CSC.

- The basic interest income is allocable to the shareholder after the end of the financial year of the CSC.

- The current allocation of income requires the application of an ordinary tax credit system which ensures a consistent relief from double taxation. The income attribution should not lead to a “penalty effect” for the shareholder, but should solely provide for the current taxation of the basic interest component. It is therefore required that the income attribution is separated from the regular domestic taxation of the shareholder and that the tax credit mechanism is modified. Without the latter separation and modification, the system might lead to a treatment which is, at least in some situations, less favourable compared to the treatment of income which is either derived directly by the shareholder or by a legal entity which is not subject to current taxation. This is particularly true in case of losses (of the shareholder, the CSC, or intermediate companies) and multiple-tier structures if different systems are applied simultaneously. Therefore, the proposed CSC legislation follows a concept which provides for the possibility of a *preliminary tax determination* and a *postponement of tax payments* in certain situations and under certain circumstances.

- The attributed income is subject to tax at the highest domestic (group) level. This can be a legal entity, an individual shareholder, or a permanent establishment of a non-resident investor (which therefore also encompasses transparent partnerships).

- If the income is attributed to an individual shareholder, it will be taxed at a flat rate which is derived from the domestic corporate income tax rate and not according to the (progressive) personnel income tax rate of the shareholder.

- The taxation according to the “regular” personnel income tax system of the individual shareholder will be made as soon as the income is actually distributed - with a full crediting of the previously imposed (preliminary) flat income tax. Finally, this ensures an identical treatment of currently attributed income and non-currently attributed income.

- The CSC legislation also provides for a consistent relief from double taxation in case of subsequent profit distributions and the subsequent disposal of shares.

- The system provides for a number of *exemptions* from the current taxation of income in order to reduce the administrative burden and to limit the scope of such legislation, as much as possible, to the situations and structures in which the risk of tax avoidance - from the perspective of the state which applies the CSC legislation - is increased. The exemption provisions have to be seen individually, i.e. if the conditions for one of the exemption provisions are fulfilled, there will be no income allocation under the CSC regime. The following exemptions have been proposed:

    - Exemption based on a property-ratio: an exemption should be granted if the non-tainted property in the balance sheet of the CSC - based on book value - prevails. I have proposed a percentage which should be in a range between more than 50 percent (minimum) and more than 75 percent (maximum).

    - Exemption based on an income ratio: similar to the property-ratio, an exemption should be granted if the income from non-tainted activities encompasses more than 50 percent (minimum) and more than 75 percent (maximum) of the total income of the CSC.

    - Exemption based on the classification of the service recipients: the tainted activities should be exempt from current taxation of income if the services are provided - to a significant percentage - to unrelated parties. This should be the case if more than 75 percent of the income from tainted activities is related to services provided towards unrelated parties.

    - Exemption based on a general financial threshold: in order to avoid that each and every minor amount of tainted investment is subject to current taxation, it seems to be acceptable to stipulate a financial threshold as an absolute amount. In my opinion, the threshold should refer to the net calculation basis of the tainted property (in total) and should be within a range of 100,000 Euro to 500,000 Euro. Thus, if the net calculation basis of the tainted property does not exceed the threshold, no income attribution is required.

    - Exemption based on income taxation at source: in those cases in which the basic interest component is not subject to taxation in the state of residence of the service company, but in the state of source, there is no necessity to calculate the basic interest component.

- It is of utmost importance that the proposed CSC legislation complies with the idea and the concept of an internal market and primary and secondary EU law. The current taxation of the basic interest component under the CSC system clearly supports, in my opinion, the efficient allocation of capital among Member States and other countries and is therefore fully in line with the idea and the concept of an internal market.

- The main aspects to ensure the effectiveness of the legislation and the compliance with *primary* EU law are the following:

    - The limitation to tainted activities which entail - from the perspective of the state which applies the legislation - an increased risk of tax avoidance (capital service activities).

    - The application of the system in a non-discriminatory manner to tainted activities carried on through resident and non-resident entities.

    - The strict limitation of the current taxation of income to the basic interest component.

    - No difference in the treatment of the basic interest income which is caused by the tax credit system, existing tax losses, multiple-tier structures et cetera.

    - The granting of non-discriminatory exemption provisions.

- *Secondary* EU law does not play a comparably important role. However, if the (revised) Parent-Subsidiary Directive is applicable to the current attribution of income under a CFC or CSC system, the respective system is required to provide for the elimination of double taxation either by applying the exemption method or the credit method. This is clearly the case for the proposed CSC legislation.

10.9.11. The outcome of the *Cadbury Schweppes* case can provoke different reactions of Member States and may lead to an increased political pressure for the introduction of an EU wide minimum income tax rate or for comparable measures of harmonisation. The final outcome from a political perspective, however, is difficult to estimate and it is quite likely that a common European approach can only be achieved in the long run. The immediate unilateral reactions which can be expected - and which can already be noticed - are either the adjustment of CFC rules in a way which complies with the requirements derived from the *Cadbury Schweppes* case, or the extension of existing CFC rules to comparable domestic investments and investments in other (high-tax) countries. However, due to the fact that a concept which is based on the conclusions of the *Cadbury Schweppes* decision would change the scope of the legislation significantly, it can be expected that some of the regimes will rather be extended to resident and non-resident entities instead of providing an “escape clause”. The Council of the European Union published a Resolution on the coordination of CFC rules which recommends that Member States adopt some guiding principles for the application of these rules. However, the Resolution only presents a list of indicators for the identification of artificial arrangements. This can be helpful to align the approach of the Member States with respect to the separation of artificial structures from non-artificial structures - but not more than that.

10.9.12. The CSC legislation only results in a conflict with a tax treaty which is based on the OECD-MTC if (i) the legislation is applied to income generated through a PE in the other contracting state and (ii) the tax treaty explicitly provides for the application of the exemption method (and not the credit method) in order to avoid the double taxation of PE income. Only in this case, it is required to explicitly refer to the application of the CSC legislation in order to avoid a tax treaty-override. However, it is apparent that the application of the CSC taxation is less “aggressive” - also in the light of the relationship with the other contracting state - than the typical CFC regimes which usually focus on all (vertical) income components. Together with the clear economic and equity reasons behind such legislation it seems to be less likely that the application of the CSC taxation results in serious conflicts with the other treaty partner. This should not be understood as a suggestion or a justification for a tax treaty-override, but it shows that the overall impact of such an override is very limited. One may even see it from a different angle: the fact that the CSC regime solely focuses on the basic interest component might open the door for an argument - supported by economic and equity reasons - to amend the respective double tax convention and to explicitly include the possibility of applying the CSC regime.

10.9.13. It is important to understand and to highlight the main differences between CFC legislation - which is extended in the manner described above - and the proposed CSC legislation. The most significant aspects can be summarised as follows:

- The extension of a transactional approach CFC legislation to resident entities may lead to an extraordinary administrative burden, especially in those cases in which all types of income from inter-company services are in the focus of the respective legislation. For this reason, a substantial amendment to the legislation may be required.

- The extension of an entity approach CFC legislation may require a revised classification, too. The reason is that the income from inter-company services is typically treated as tainted income and, therefore, might lead to a complete income allocation if it encompasses a substantial part of the overall income of the CFC.

- The transactional and entity approach CFC legislation which applies to resident and non-resident entities - without focusing on the income tax rate - does not solve the problem of income allocation which is related to the activity component and the risk component of capital. The contrary is true: the extension of the system to medium- and high-tax countries increases the amount of “critical” income allocation.

- The increase in income allocation which is related to the activity component and the risk component is not limited to tainted income, but also “infects” non-tainted income if the CFC legislation follows an entity approach. This would lead to a massive extension of the taxation of income components which should be - based on the principles outlined in earlier chapters - exempt from current taxation.

- The extension of the CFC taxation would by no means solve the problems which are caused by the inconsistent application of the tax credit system, the asymmetrical allocation of income, the inclusion of the income in the tax base of the shareholder, et cetera. It might even lead to *additional* conflicts. The latter can be the case, for example, if the domestic legislation provides a system of fiscal unity (fiscal consolidation) only for domestic entities: the exclusion of negative income of a non-resident CFC from an offsetting with positive income of the shareholder, on the one hand, but an offsetting of negative income of a resident CFC under the fiscal unity regime, on the other hand, would lead to a situation which, in my view, is not in line with the concept and the idea of an internal market.

- A simple extension of CFC rules to resident entities is, in essence, not sufficient to fulfil the needs and the requirements of an internal market - even if the extension is implemented in a manner which leads to a non-discriminatory legislation and may therefore theoretically be in line with the basic freedoms of the TFEU.

- The CFC legislation often focuses on the lowest domestic group level, i.e. does not allocate the income to the ultimate domestic shareholder. This opens the possibility for structures which minimise the anti-avoidance effect. In contrast thereto, the proposed CSC legislation focuses on the shareholder on the highest domestic group level, be it an individual shareholder or a corporate shareholder.

- The mechanism of CFC legislation can result in significant distortions, with the effect that the overall tax burden caused by the CFC income allocation is higher than a comparable dividend distribution. The CSC legislation is based on a two-step approach: first, the current allocation of the basic interest component and, second, the regular dividend distribution (or the disposal of shares). Both steps are linked closely in order to avoid any double taxation of income.

- The proposed CSC legislation follows an approach which is “softer” compared to CFC legislation, but without being less effective. The system focuses on the direct and indirect shareholder, but taxes the basic interest income only if the income is finally subject to tax in the CSC state. The system provides for postponements of tax payments and preliminary assessments to ensure the avoidance of double taxation, and to ensure that currently attributed income is not treated worse than any other income which is not subject to current taxation (no “penalisation” of the shareholder).

Table of Case Law of the European Court of Justice

ECJ 21 June 1974, Case 2/74 (*Reyners*)
ECJ 11 July 1974, Case 8/74 (*Dassonville*)
ECJ 3 December 1974, Case 33/74 (*Van Binsbergen*)
ECJ 12 December 1974, Case 36/74 (*Walrave*)
ECJ 28 November 1978, Case 22/87 (*Somafer*)
ECJ 7 February 1979, Case 115/78 (*Knoors*)
ECJ 20 February 1979, Case 120/78 (*Cassis de Dijon*)
ECJ 9 February 1982, Case 270/80 (*Polydor*)
ECJ 1 April 1982, Case 89/81 (*Hong Kong*)
ECJ 31 January 1984, Cases 286/82 and 26/83 (*Luisi and Carbone*)
ECJ 14 February 1985, Case 268/83 (*Rompelman*)
ECJ 28 January 1986, Case 270/83 (*Commission vs France*)
ECJ 10 July 1986, Case 79/85 (*Segers*)
ECJ 27 September 1988, Case 81/87 (*Daily Mail*)
ECJ 13 December 1989, Case C-49/89 (*Corsica Ferries France*)
ECJ 14 December 1989, Case C-216/87 (*Jaderow*)
ECJ 8 May 1990, Case C-175/88 (*Biehl*)
ECJ 14 December 1990, Case C-186/89 (*Van Tiem*)
ECJ 20 June 1991, Case C-60/90 (*Polysar*)
ECJ 25 July 1991, Case C-221/89 (*Factortame II*)
ECJ 25 July 1991, Case C-288/89 (*Stichting Collectieve*)
ECJ 25 July 1991, Case C-76/90 (*Säger*)
ECJ 4 October 1991, Case C-246/89 (*Commission v United Kingdom*)
ECJ 28 January 1992, Case C-204/90 (*Bachmann*)
ECJ 28 January 1992, Case C-300/90 (*Commission v Belgium*)
ECJ 26 January 1993, Case C-112/91 (*Werner*)
ECJ 22 June 1993, Case C-333/91 (*Sofitam*)
ECJ 3 March 1994, Case C-16/93 (*Tolsma)*
ECJ 14 July 1994, Case C-379/92 (*Peralta*)
ECJ 14 February 1995, Case C-279/93 (*Schumacker*)
ECJ 11 August 1995, Case C-80/94 (*Wielockx*)
ECJ 14 November 1995, Case C-484/93 (*Svensson and Gustavsson*)
ECJ 30 November 1995, Case C-55/94 (*Gebhard*)
ECJ 14 December 1995, Cases C-163/94 and 250/94 (*Sanz de Lera*)
ECJ 13 February 1996, Cases C-197/94 and 252/94 (*Bautiaa / Société francaise maritime)*
ECJ 30 April 1996, Case C-214/94 (*Boukhalfa*)
ECJ 20 June 1996, Case C-155/94 (*Wellcome Trust*)
ECJ 27 June 1996, Case C-107/94 (*Asscher*)
ECJ 26 September 1996, Case C-230/94 (*Enkler*)
ECJ 24 October 1996, Case C-288/94 (*Argos*)
ECJ 6 February 1997, Case C-80/95 (*Harnas)*
ECJ 15 May 1997, Case C-250/95 (*Futura*)
ECJ 5 June 1997, Case C-2/95 (*SDC*)
ECJ 17 July 1997, Case C-28/95 (*Leur-Bloem*)
ECJ 11 December 1997, Case C-55/96 (*Job Centre*)
ECJ 28 April 1998, Case C-120/95 (*Decker)*
ECJ 28 April 1998, Case C-118/96 (*Safir*)

ECJ 28 April 1998, Case C-158/96 (*Kohll*)
ECJ 12 May 1998, Case C-336/96 (*Gilly*)
ECJ 16 July 1998, Case C-264/96 (*ICI*)
ECJ 9 March 1999, Case C-212/97 (*Centros*)
ECJ 16 March 1999, Case C-222/97 (*Trummer and Mayer*)
ECJ 29 April 1999, Case C-311/97 (*Royal Bank of Scotland*)
ECJ 1 June 1999, Case C-302/97 (*Konle*)
ECJ 8 July 1999, Case C-254/97 (*Baxter and Others*)
ECJ 14 September 1999, Case C-391/97 (*Gschwind*)
ECJ 21 September 1999, Case C-307/97 (*Saint-Gobain*)
ECJ 14 October 1999, Case C-439/97 (*Sandoz*)
ECJ 26 October 1999, Case C-294/97 (*Eurowings*)
ECJ 28 October 1999, Case C-55/98 (*Vestergaard*)
ECJ 18 November 1999, Case C-200/98 (*X and Y*)
ECJ 15 February 2000, Case C-34/98 (*Commission v France*)
ECJ 13 April 2000, Case C-251/98 (*Baars*)
ECJ 16 May 2000, Case C-87/99 (*Zurstrassen*)
ECJ 6 June 2000, Case C-35/98 (*Verkooijen*)
ECJ 14 November 2000, Case C-142/99 (*Floridienne and Berginvest*)
ECJ 14 December 2000, Case C-110/99 (*Emsland Stärke*)
ECJ 14 December 2000, Case C-141/99 (*AMID*)
ECJ 8 March 2001, Cases C-397/98 (*Metallgesellschaft*) and 410/98 (*Hoechst*)
ECJ 12 July 2001, Case C-102/00 (*Welthgrove*)
ECJ 27 September 2001, Case C-16/00 (*Cibo Participations*)
ECJ 4 October 2001, Case C-294/99 (*Athinaiki Zythopoiia*)
ECJ 30 May 2002, Case C-516/99 (*Walter Schmid*)
ECJ 4 June 2002, Case C-367/98 (*Commission v Portugal*)
ECJ 4 June 2002, Case C-483/99 (*Commission v France*)
ECJ 3 October 2002, Case C-136/00 (*Danner*)
ECJ 5 November 2002, Case C-208/00 (*Überseering*)
ECJ 21 November 2002, Case C-436/00 (*X and Y*)
ECJ 12 December 2002, Case C-324/00 (*Lankhorst-Hohorst*)
ECJ 26 June 2003, Case C-305/01 (*MKG-Kraftfahrzeuge*)
ECJ 26 June 2003, Case C-422/01 (*Skandia*)
ECJ 18 September 2003, Case C-168/01 (*Bosal Holding*)
ECJ 23 September 2003, Case C-452/01 (*Ospelt und Schlössle Weissenberg*)
ECJ 30 September 2003, Case C-167/01 (*Inspire Art*)
ECJ 11 December 2003, Case C-364/01 (*Barbier*)
ECJ 4 March 2004, Case C-334/02 (*Commission v France*)
ECJ 11 March 2004, Case C-9/02 (*Lasteyrie du Saillant*)
ECJ 29 April 2004, Case C-77/01 (*EDM*)
ECJ 8 June 2004, Case C-268/03 (*De Baeck*)
ECJ 15 July 2004, Case C-315/02 (*Lenz*)
ECJ 7 September 2004, Case C-319/02 (*Manninen*)
ECJ 5 July 2005, Case C-376/03 (*D*)
ECJ 13 December 2005, Case C-446/03 (*Marks & Spencer*)
ECJ 21 February 2006, Case C-255/02 (*Halifax and Others*)
ECJ 23 February 2006, Case C-471/04 (*Keller Holding*)
ECJ 23 February 2006, Case C-513/03 (*van Hilten*)
ECJ 12 September 2006, Case C-196/04 (*Cadbury Schweppes*)
ECJ 3 October 2006, Case C-290/04 (*Scorpio*)

ECJ 3 October 2006, Case C-452/04 (*Fidium Finanz*)
ECJ 12 December 2006, Case C-374/04 (*ACT*)
ECJ 12 December 2006, Case C-446/04 (*Test Claimants in the FII Group Litigation*)
ECJ 30 January 2007, Case C-150/04 (*Commission v Denmark*)
ECJ 6 March 2007, Case C-292/04 (*Meilicke*)
ECJ 13 March 2007, Case C-524/04 (*Thin Cap GLO)*
ECJ 29 March 2007, Case C-347/04 (*Rewe Zentralfinanz*)
ECJ 10 May 2007, Case C-102/05 (*A and B*)
ECJ 10 May 2007, Case C-492/04 (*Lasertec*)
ECJ 24 May 2007, Case C-157/05 (*Holböck*)
ECJ 5 July 2007, Case C-321/05 (*Kofoed)*
ECJ 18 July 2007, Case C-231/05 (*Oy AA*)
ECJ 11 October 2007, Case C-451/05 (*ELISA)*
ECJ 6 November 2007, Case C-415/06 (*Stahlwerk Ergste Westig*)
ECJ 6 December 2007, Case C-298/05 (*Columbus Container*)
ECJ 18 December 2007, Case C-101/05 *(A*)
ECJ 17 January 2008, Case C-105/07 (*Lammers & van Cleeff*)
ECJ 21 February 2008, Case C-425/06 (*Part Service*)
ECJ 15 May 2008, Case C-414/06 (*Lidl Belgium*)
ECJ 20 May 2008, Case C-194/06 (*Orange European Smallcap Fund*)
ECJ 22 May 2008, Case C-162/07 (*Ampliscientifica*)
ECJ 26 June 2008, Case C-284/06 (*Burda)*
ECJ 11 September 2008, Case C-433/06 (*Hollmann*)
ECJ 23 October 2008, Case C-157/07 (*Krankenheim Ruhesitz am Wannsee*)
ECJ 27 November 2008, Case C-418/07 (*Papillon*)
ECJ 11 December 2008, Case C-285/07 (*A.T.)*
ECJ 16 December 2008, Case C-210/06 (*Cartesio*)
ECJ 22 December 2008, Case C-282/07 (*Truck Center*)
ECJ 12 February 2009, Case C-67/08 (*Block*)
ECJ 11 June 2009, Case C-521/07 (*Commission v Netherlands*)
ECJ 16 July 2009, Case C-128/08 (*Damseaux*)
ECJ 17 September 2009, Case C-182/08 (*Glaxo Wellcome*)
ECJ 19 November 2009, Case C-540/07 (*Commission v Italy*)
ECJ 21 January 2010, Case C-311/08 (*SGI*)
ECJ 25 February 2010, Case C-337/08 (*X Holding*)
ECJ 28 October 2010, Case C-72/09 (*Rimbaud*)
ECJ 5 May 2011, Case C-384/09 (*Prunus*)

Bibliography

Aigner Dietmar J. / Kofler, Georg, Steuerliche Folgen des Zuzugs von EU-Kapitalgesellschaften nach Österreich nach der Rechtsprechung des EuGH in der Rs. Überseering (C-208/00), Internationales Steuerrecht (IStR) 2003, 570 et seq.

Aigner, Dietmar J. / Kofler, Georg, Austria Clarifies Third-Country Impact of ECJ's Lenz Decision, Tax Notes International 2004, 477 et seq.

Aigner, Hans-Jörgen, CFC-Gesetzgebung und DBA-Recht, Steuer und Wirtschaft International (SWI) 2002, 407 et seq.

Aigner, Hans-Jörgen, Die Abkommensberechtigung bei Anwendung von CFC-Gesetzgebungen, Internationale Wirtschafts-Briefe (IWB) 2002, Fach 10, Gruppe 2, 1637 et seq.

Aigner, Hans-Jörgen, Hinzurechnungsbesteuerung und DBA-Recht, Schriftreihe zum Internationalen Steuerrecht, Michael Lang (ed.), Linde Verlag, Vienna 2004

Aitken, Roopa, The "Thin Cap" End of the Wedge?, Tax Planning International Review 2006, 12 et seq.

Aitken, Roopa, Vodafone Pressurises CFC Rules, The Tax Journal 2008, 5 et seq.

Aitken, Roopa., Sweet Victory for Cadbury Schweppes?, IT Rep. 2006, 1 et seq.

Almudi, José Manuel, National Report Spain, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 559 et seq.

Altshuler, Rosanne, Recent Developments in the Debate on Deferral, Tax Notes, April 2000, 255 et seq.

Amat, Pedro / Monasterio, Pablo, Spain: Controlled Foreign Corporation Legislation, Bulletin for International Fiscal Documentation 1995, 289 et seq.

Amato, Jeffery D. / Remolona, Eli M., Das Rätsel der Bonitätsaufschläge, BIZ-Quartalsbericht, December 2003, 57 et seq.

Amonn, Toni, Zweitinstanzliches Urteil zur Anwendbarkeit der französischen CFC-Regelung im Verhältnis zur Schweiz, Archiv für Schweizerisches Abgaberecht 2001, 177

Andersen, Peter S., Denmark: New International Tax Bill Enacted, European Taxation 1996, 376 et seq.

Andulf Advokat AB, Sweden: Tax and Legal Developments, January 2004
Anthony, R., France-Switzerland Treaty Overrides CFC Legislation, French Courts Says, International Tax Report 2002, 10-11

Arginelli, Paolo / Gusmeroli, Michele, The 2007 Leiden Alumni Forum on Recent and Pending Direct Taxation Cases Before the European Court of Justice, Intertax 2008, 312 et seq.

Arginelli, Paolo, The Discriminatory Taxation of Permanent Establishments by the Host State in the European Union: a Too Much Separate Entity Approach, Intertax 2007, 82 et seq.

Arnold Brian J. / Dibout, Patrick, General Report, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 21 et seq.

Arnold, Brian J., The Taxation of Controlled Foreign Corporations: An International Comparison, Canadian Tax Paper No. 78, Canadian Tax Foundation, Tortonto 1986

Aucejo, Eva Andrés / Marcilla, Santiago Ibánez, An Overview of the New Spanish Corporate Income Tax Law, Intertax 1997, 254 et seq.

Ault, Hugh J., The Role of the OECD Commentaries in the Interpretation of Tax Treaties, in: Essays on International Taxation, Alpert, Herbert H. / van Raad, Kees (eds.), Kluwer, Boston 1993, 61 et seq.

Avery Jones, John F., The Effect of Changes in the OECD Commentaries after a Treaty is Concluded, Bulletin for International Fiscal Documentation 2002, 102 et seq.

Axer, Georg, Der Europäische Gerichtshof auf dem Weg zur „doppelten Kohärenz“: Eine Zukunft der Hinzurechnungsbesteuerung nach dem Cadbury Schweppes-Urteil, Internationales Steuerrecht (IStR) 2007, 162 et seq.

Baker, Philip, Pending Cases Filed by the UK Courts I: The Cadbury Schweppes Case, the CFC and Dividend GLO Case, and the Vodafone 2 Case, in: Lang, Michael / Schuch, Josef / Staringer, Claus, ECJ - Recent Developments in Direct Taxation, EUCOTAX Series on European Taxation, Linde Verlag, Vienna 2006, 311 et seq.

Baker, Philip, Seminar B: Jüngste Entwicklungen im Internationalen Steuerrecht, Internationales Steuerrecht (IStR) 2002, 546 et seq.

Baker, Philip, UK: Forthcoming UK Case: *FII GLO* (Part 2), in: Lang, Michael / Pistone, Pasquale / Schuch, Josef / Staringer, Claus / Storck, Alfred (eds.), ECJ - Recent Developments in Direct Taxation 2010, Series on International Tax Law, Michael Lang (ed.), Volume 67, Linde Verlag, Vienna 2011, 223 et seq.

Bakker, Hans / van de Rijt, Wendela, Netherlands Corporate Income Tax Reform 2007 - Bill “Working on Profit”, Bulletin for International Taxation 2006, 308 et seq.

Balmes, Frank / Ribbrock, Martin, Die Schlussanträge in der Rechtssache Meilicke: Vorschlag einer zeitlichen Begrenzung der Wirkung des Urteils „auf Zuruf“ der Mitgliedstaaten?!, Betriebs-Berater (BB) 2006, 17 et seq.

Balster, Benedikt / Petereit, Axel, Anrechnung ausländischer Steuern nach dem EuGH-Urteil in der Rechtssache “Manninen” trotz Bestandskraft!, Deutsches Steuerrecht (DStR) 2004, 1985 et seq.

Bardini, Chiara, The Fine Line between Anti-Abuse Measures and the Delimitation of a Member State’s Tax Jurisdiction: The Italian Case, European Taxation 2010, 374 et seq.

Barenfeld, Jesper, Sweden’s New CFC Regime after *Cadbury Schweppes* - Comments and Analysis, Bulletin for International Taxation 2008, 295 et seq.

Baumhoff, Hubertus / Leitner, Reinhard / Digeronimo, Angelo, Betriebsstättengewinnermittlung im internationalen Vergleich - Deutschland, Österreich, Schweiz, Internationale Wirtschafts-Briefe (IWB) 2000, Fach 10, Gruppe 2, 1433 et seq.

BBC News - Business, Portugal Hit by Debt Downgrade from Ratings Agency, March 16, 2011

Becker, Helmut / Höppner, Horst-Dieter / Grotherr, Siegfried / Kroppen, Heinz-Klaus (eds.), DBA-Kommentar zu den Doppelbesteuerungsabkommen (loose leaf), Verlag Neue Wirtschafts-Briefe, Herne / Berlin 2005

Becker, Jan / Hölscher, Sebastian / Loose, Thomas, Impact of ECJ’s Cadbury Schweppes Decision on German Tax Planning, Tax Notes International 2007, 879 et seq.

Becker, Katharina / Sydow, Sabine, Das EuGH-Urteil in der belgischen Rechtssache C-311/08 *SGI* und seine Implikationen für die Frage der Europarechtmäßigkeit des § 1 AStG, Internationales Steuerrecht (IStR) 2010, 195 et seq.

Beiser, Reinhold, Die “kleine Vermietung” in der Umsatz- und Einkommensteuer: eine gemeinschaftsrechtliche und verfassungsrechtliche Analyse, Steuer und Wirtschaftskartei 2006, 666 et seq.

Belgian Co-ordination Centre Deemed by Finnish Court to be a CFC, Tax News Service (TNS), 33/2002, July 11, 2002

Bellstedt, Christoph, Die Besteuerung international verflochtener Gesellschaften, 3. Auflage, O. Schmidt, Köln 1973

Bérengier, Eric, French Administrative Supreme Court Holds that Tax Treaties Override French CFC Rules, Tax Planning International Review 2002, 3 et seq.

Bergström, Sture / Bruzelius, Anette, Home-State Restrictions on the Freedom of Establishment in a Swedish Income Tax Law Perspective, Intertax 2001, 233 et seq.

Bernatonis, Julius, National Report Lithuania, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC

Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 391 et seq.

Bernsen, Jonathan / Byrgesen, Benedicte / Markholst, Andrea, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Denmark, International Transfer Pricing Journal 2008, 35 et seq.

Biebl, Ernst, Niederlassungsfreiheit und Zuzug doppelt ansässiger Kapitalgesellschaften, Steuer und Wirtschaft International (SWI) 2003, 168 et seq.

Birk, Dieter, Zuzug und Wegzug von Kapitalgesellschaften - zu den körperschaftsteuerlichen Folgen der Überseeringentscheidung des EuGH, Internationales Steuerrecht (IStR) 2003, 469 et seq.

Björkeson, Erik, The New Holding Company Regime in Sweden, Tax Planning International Review 2004, 15 et seq.

Bjornholm, Nicolaj / Klemp, Maj-Britt, The Year in Review: Denmark, Tax Notes International 2007, 1338 et seq.

Bjornholm, Nicolaj / Rubinstein, Anders, Denmark: Do the Lenz and Manninen Decisions Invalidate Danish Dividend and CFC Taxation, Tax Notes International 2004, 286 et seq.

Blaise, D., Fiscalité internationale: article 209 B et conventions fiscales', Bulletin Fiscal Francis Lefebvre, 11/02, 763

Bloomberg, Spain's Rating Downgraded to Aa2 by Moody's Over Bank Cost Concerns, March 10, 2011

Bluhm, Christian / Overbeck, Ludger / Wagner, Christoph, An Introduction to Credit Risk Modelling, Chapman Hall, Cambridge / Maryland / London 2002

Boekhorst, Paul Te, Dutch Dividend Relief in Breach of E.U. Law, Tax Planning International European Union Focus 2000, 21 et seq.

Bogaert, Jerome / Jean-Alphonse, Charles, France - Developments in 2006 and Prospects for 2007, Tax Planning International Transfer Pricing 2007, 13 et seq.

Böing, Christian, Der Begriff des steuerlichen Gestaltungsmißbrauchs im Gemeinschaftsrecht: Eine aktuelle Bestandsaufnahme der steuerlichen Mißbrauchsrechtsprechung des EuGH (zuletzt „Halifax" und „Cadbury Schweppes"), Europäisches Wirtschafts- und Steuerrecht (EWS) 2007, 55 et seq.

Borges, Ricardo, National Report Portugal, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 527 et seq.

Bourtourault, Pierre-Yves / Mbwa-Mboma, Marcellin N., French High Tax Court Confirms that the Former France-Switzerland Tax Treaty Overrides the French CFC Legislation, Intertax 2002, 493 et seq.

Boutell, Michael / Nichols, Mark, European Court Supports UK Thin Capitalisation Rules, Tax Planning International European Tax Service 2007, 25 et seq.

Brähler, Katharina, Controlled Foreign Companies-Rules - Eine steuersystematische Analyse im Rahmen eines Ländervergleichs unter Berücksichtigung der Vereinbarkeit mit den Doppelbesteuerungsabkommen und dem Europäischen Gemeinschaftsrecht, Verlag Peter Lang, Frankfurt 2007

Branco / Berry / Lugthart / Veloci, CFC Rules Prevail over Treaty Application, Transfer Pricing International, August 2006

Brennan, Pascal, Why the ECJ should not follow Advocate General Maduro's Opinion in *Halifax*, International VAT Monitor 2005, 247 et seq.

Breuninger, Gottfried, Zur Umsetzung der Mutter-Tochter Richtlinie nach dem Steueränderungsgesetz 1992, Europäisches Wirtschafts- und Steuerrecht (EWS) 1992, 85 et seq.

Brezing, Klaus / Krabbe, Helmut / Lempenau, Gerhard, Außensteuerrecht, Kommentar, Verlag Neue Wirtschafts-Briefe, Herne 1998

Broe de, Luc / Bammens, Niels, Belgian Withholding Tax on Interest Payments to Non-resident Companies Does Not Violate EC Law: A Critical Look at the ECJ's Judgment in *Truck Center*, EC Tax Review 2009, 131 et seq.

Broe de, Luc, Are we Heading towards an Internal Market without Dividend Withholding Tax but with Interest and Royalty Withholding Tax? Some Observations on Advocate General's Kokott Opinion in *Truck Center*, EC Tax Review 2009, 2 et seq.

Broe de, Luc, Some Observations on the 2007 Communication from the Commission: 'The Application of Anti-Abuse Measures in the Area of Direct Taxation within the EU and in Relation to Third Countries', EC Tax Review 2008, 142 et seq.

Brokelind, Cécile, Group Taxation and CFC Rules in Swedish Tax Cases, Tax Notes International 2005, 237 et seq.

Brokelind, Cécile, Royalty Payments: Unresolved Issues in the Interest and Royalties Directive, European Taxation 2004, 252 et seq.

Brokelind, Cècile, Ten Years of Application of the Parent-Subsidiary Directive, EC Tax Review 2003, 158 et seq.

Bruin de, Maarten / Molenaars, Michael L., European Court of Justice Hands Down Decision on EU Merger Directive, Tax Notes International 1997, 424 et seq.
Budget Bill Revises Capital Gains Tax Regime, Tax Analysts Tax Document Service 2001, Doc 2001-28988

Bühler, Ottmar, Prinzipien des Internationalen Steuerrechts: Ein systematischer Versuch, Internationales Steuerdokumentationsbüro, Amsterdam 1964

Bullinger, Patrick, Inländerdiskriminierung im Steuerrecht am Beispiel des Par. 8 Nr. 7 GewStG, Internationales Steuerrecht (IStR) 2005, 370 et seq.

Bunjes, Johann / Geist, Reinhold, Umsatzsteuer, Kommentar, 7. Auflage, C.H. Beck, München 2005

Busetto Domenico / Russo, Antonio, Italy: Final Controlled Foreign Companies Legislation Enacted, European Taxation 2001, 32 et seq.

Busetto, Domenico / Russo, Antonio, Italian CFC Regime: Updates, Tax Planning International Review 2000, 6 et seq.

Calderón Jose / Baez, Andrés, *The Columbus Container Services* ECJ Case and Its Consequences: A Lost Opportunity to Shed Light on the Scope of the Non-discrimination Principle, Intertax 2009, 212 et seq.

Calderón, Jose, Spain, Tax Notes International 2004, 86 et seq.

Calderón, Jose, Spain’s Antiabuse Approach and ECJ Jurisprudence, Tax Notes International 2005, 1031 et seq.

Carréno, F., Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Spain, International Transfer Pricing Journal 2007, 338 et seq.

Casero, Ramón, Spain: New Holding Company Regime for Outbound Investments, Intertax 1996, 466 et seq.

Casero, Ramón, The Foreign Base Company in the Spanish Tax Law, Intertax 1995, 581 et seq.

Casley, Andrew / Webb-Martin, Loic, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: United Kingdom, International Transfer Pricing Journal 2007, 341 et seq.

CFE ECJ Task Force on ECJ, *Columbus Container Services BVBA & Co v. Finanzamt Bielefeld-Innenstadt*, 6 December 2007, C-298/05 - April 2008, European Taxation 2008, 541 et seq.

Chadwick, A. / O’Gara, P., ECJ Decision in Cadbury Schweppes, Tax Planning International European Union Focus 2006, 16 et seq.

Chahid-Nourai, N. / Couturier, P., L’article 209 B est-il soluble dans le droit fiscal international?, Revue de Droit Fiscal 2001, 333 et seq.

Clayson, Murray, The Impact of European Law and Treaty Relief on the UK Controlled Foreign Companies Rules, Intertax 1998, 326 et seq.

Cloer, A./ Lavrelashvili, N. / Biebl, E., Rechtssache Columbus: Unilateraler Switch-over im Fokus des Gemeinschaftsrechts, Steuer und Wirtschaft International (SWI) 2007, 359 et seq.

Cloer, Adrian, Ausschluss der Steuergutschrift für Dividenden von Aktiengesellschaften mit Sitz in anderem Mitgliedstaat - Verstoss gegen Kapitalverkehrsfreiheit? Begrenzung der zeitlichen Wirkung des Urteils? - Schlussanträge Rs. Meilicke, Europäisches Wirtschafts- und Steuerrecht 2006, 36 et seq.

Coin, Raphael, French CFC Rules in Conflict With French-Swiss Income Tax Treaty, Paris Court Says, Tax Notes International 2001, 1233 et seq.

Conci, Paolo / Kessler, Wolfgang / Puricelli, Simone / Schommer, Achim, Die Hinzurechnungsbesteuerung in Italien, Internationales Steuerrecht (IStR) 2002, 763 et seq.

Conseil d'Etat Decision on Tax Treaty Overriding CFC Legislation, Tax Notes International 2002, page 265

Controlled Foreign Companies Proposals may not be EU Compliant, Experts Warn, Tax Journal, July 5, 2011

Corabi Giampaolo / Giavolucci, Daniela, Tax Planning and Business Internationalisation, Tax Planning International Review 2000, 7 et seq.

Corabi, Giampaolo, The New Italian CFC Regime, Tax Planning International Transfer Pricing 2001

Corben, Heahter, Commentary on the ICI v Colmer Case, The EC Tax Journal 1998, 29 et seq.

Cordewener, Axel / Dahlberg, Matthias / Pistone, Pasquale / Reimer, Ekkehart / Romano, Carlo, The Tax Treatment of Foreign Losses: *Ritter, M & S*, and the Way Ahead (Part Two), European Taxation 2004, 218 et seq.

Cordewener, Axel / Kofler Georg / Schindler, Clemens, Free Movement of Capital, Third Country Relationships and National Tax Law: An Emerging Issue before the ECJ, European Taxation 2007, 107 et seq.

Cordewener, Axel / Kofler, Georg / Schindler, Clemens, Free Movement of Capital and Third Countries: Exploring the Outer Boundaries with *Lasertec, A and B* and *Holböck*, European Taxation 2007, 371 et seq.

Cordewener, Axel, Europäische Grundfreiheiten und nationales Steuerrecht: „Konvergenz“ des Gemeinschaftsrechts und „Kohärenz“ der direkten Steuern in der Rechtsprechung des EuGH, O. Schmidt, Köln 2002

Cordewener, Axel, German 'Anti-Avoidance' Measures Versus Belgian Coordination Centres: A Long Struggle Without Survivors?, in: Luc Hinnekens and Philippe Hinnekens (eds.), A Vision of Taxes Within and Outside European Borders.

Festschrift in Honour of Prof. Dr. Frans Vanistendael, Kluwer Law International, The Hague 2008, 203 et seq.

Coutinho, Kelly, *Vodafone 2*: Does it Matter?, Tax Planning International Review, July 2008

Craig, Adam, EC Tax Scene: Challenge to UK CFC Legislation Referred to ECJ, Intertax 2004, 530 et seq.

Cripps, M., Cadbury Schweppes Case, CSR 2006, 24

Cristie, L./ Sheiham, M., Bricom, The Tax Journal 1997, 13 et seq.

Crockford, Neil, An Introduction to Risk Management, Woodhead-Faulkner, Cambridge 1986

Cueva González-Cotera, Alvaro, Spain: New Anti-Avoidance Rules in the Individual Income Tax Law, European Taxation 1999, 141 et seq.

Cunningham, William, Portugal: Portugal Introduces CFC Legislation, Tax News Service (TNS) 1995, 111

Cussons, Peter / Gordon-Brown, Michael, Controlled Foreign Companies - Section 104, British Tax Review 2000, 501 et seq.

Cussons, Peter, The Sleeping Dragons Stir, The Tax Journal 1999, 11 et seq.

Cussons, Peter, The Wider European Implications of *the ICI v. Colmer* Judgement, Tax Planning International Review 1999, 10 et seq.

D'Hont, Pascal / Souchal, Nelly, Significant CFC Victory for Taxpayers, Tax Planning International Review 2001

D'Hont, Pascal, France: Sweeping Tax Changes Affecting In/Outbound Investments, Tax Planning International Review 2004

Dahlberg, Matthias, National Report Sweden, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 581 et seq.

Dahlberg, Matthias, National Report Sweden, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 827 et seq.

Daiber, Claudia / Offermanns, René, Gleichbehandlung von Kapitalerträgen aus Quellen innerhalb der Europäischen Union für steuerliche Zwecke, Internationale Wirtschafts-Briefe (IWB) 2004, Fach 11A, 795 et seq.

Dam van, H., Dutch Corporation Tax Reform 2007 - Bill “Working on Profit” Submitted to Parliament, Tax Planning International European Union Focus 2006, 6 et seq.

Daniels, Ton, The Freedom of Establishment: Some Comments on the *ICI* Decision, EC Tax Review 1999, 39 et seq.

Das, Sanjiv R. / Fong, H. Gifford / Geng, Gary, Impact of Correlated Default Risk on Credit Portfolios, Journal of Fixed Income, December 2001, 9 et seq.

Deák, Daniel, National Report Hungary, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 549 et seq.

Debatin, Helmut / Wassermeyer, Franz, Doppelbesteuerung, Kommentar, C.H. Beck, München, 2003

Debatin, Helmut, StÄndG 1992 und „Treaty Override“, Der Betrieb (DB) 1992, 2159 et seq.

Deininger, Rainer, Körperschaftsteuerliche Auswirkungen der Überseering-Entscheidung des EuGH, Internationales Steuerrecht (IStR) 2003, 214 et seq.

Delattre, O. / Streiff, D., France Seeks to Stem Tax Evasion by Tightening CFC Rules, Tax Notes International 1992, 807 et seq.

Delbrück, Hans-Helmuth / Hamacher, Rolfjosef, Meilicke und die Rückwirkung - Zu Par. 130 AO bei der praktischen Umsetzung des EuGH-Urteils Meilicke, Internationales Steuerrecht (IStR) 2007, 627 et seq.

Dell’ Anese, Luca, Italian Parliament Approves CFC Legislation, Tax Notes International 2000, 550 et seq.

Deloitte, Controlled Foreign Company Regimes Essentials 2011, Country Report France

Deloitte, Controlled Foreign Company Regimes Essentials 2011, Country Report UK

Delphi & Co., New CFC legislation introduced in Sweden, December 2003, 1

Den Boer, Steven, Freedom of Establishment versus Free Movement of Capital: Ongoing Confusion at the ECJ and in the National Courts?, European Taxation 2010, 250 et seq.

Desborough-Hurst, Matthew, Advocate General Says Controlled Foreign Companies Rules can be Compatible with EU Law, International Tax Review 2006, 102 et seq.

Deuchar, Gay / Steel, Tim, UK Throws Out Controlled Foreign Companies Regime, International Tax Review 2008, 41 et seq.

Deventer van, Donald R. / Imai, Kenji / Mesler, Mark, Advanced Financial Risk Management: Tools and Techniques for Integrated Credit Risk and Interest Rate Risk Management, John Wiley & Sons, Singapore 2005

Dibout, Patrick, L'inapplicabilité de l'article 209 B du CGI face à la Convention fiscale franco-suisse du 9 septembre 1977, Revue de Droit Fiscal 2002, no. 36, 1133 et seq.

Dicker, A.J.W., United Kingdom: Controlled Foreign Company Legislation, European Taxation 1985, 67 et seq.

Dietz, Henrik / Buxbom, Dan, Denmark: New Less Restrictive CFC Legislation, European Taxation 2002, 515 et seq.

Dikmans, Sylvia, New Netherlands Corporate Income Tax Provisions for 2007, European Taxation 2007, 158 et seq.

Dodwell, Bill / Serrau, Carolyn, Cadbury Schweppes: The Future of CFC Legislation, Tax Adviser (July) 2006, 27

Dodwell, Bill / Williams, Richard / Pleasant, Joanne, CFCs and Cadbury Schweppes, The Tax Journal 2006, 7 et seq.

Dodwell, Bill, ECJ Rules on Belgian Anti-Abuse Rule on Exceptional and Gratuitous Advantages, Intertax 2010, 253 et seq.

Doernberg, Richard / Hinnekens, Luc / Hellerstein, Walter / Li, Jinyan, Electronic Commerce and Multijurisdictional Taxation - Applying Current Multijurisdictional Income Tax Rules to Electronic Commerce, Kluwer Law International, The Hague 2001

Dolton, A., Cadbury Schweppes Plc v CIR, Tax Journal 2006, 3

Donsimoni, Patrick, Schneider Case Clarifies Application of Tax Treaties to French Companies, Tax Analysts Tax Document Service 2002, Doc. 2002-18637

Dourado, Ana Paula, Portugal: Anti-Abuse Clauses, EC Tax Review 1995, 273

Douvier, Pierre-Jean / Bouzoraa, Dali, Court of Appeals Confirms Incompatibility of CFC Rules with Tax Treaties, European Taxation 2001, 184 et seq.

Douvier, Pierre-Jean, CFC Legislation: An Analysis of Article 209B - The Net Widens!, Bulletin for International Fiscal Documentation 1995, 401 et seq.

Douvier, Pierre-Jean, France: Major Measures Concerning International Taxation, Bulletin for International Fiscal Documentation, 1993, 215 et seq.

Douvier, Pierre-Jean, National Report France, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 495 et seq.

Douvier, Pierre-Jean, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: France, International Transfer Pricing Journal 2007, 327 et seq.

Duffie, Darrell / Singleton, Kenneth J., Credit Risk: Pricing, Measurement, and Management, Princeton Series in Finance, Princeton 2003

Dussert, Bertrand, The Italian CFC Provisions: Traced from a French Model, or Another Italian Renaissance?, European Taxation 2002, 522 et seq.

Eckl, Petra, The Tax Regime for Controlled Foreign Corporations, European Taxation, 2003, 2 et seq.

Edge, Stephen, More Fresh Orange Juice?, The Tax Journal 2006, 11 et seq.

Ehlermann, C., News Analysis: Implications of Cadbury Schweppes Opinion on German CFC Legislation, Worldwide Tax Daily (WTD), May 18, 2006

Eicker, Klaus / Ketteler, Thomas, Die verfahrensrechtliche Durchsetzung von Gemeinschaftsrecht im Steuerrecht am Beispiel der Rs. Manninen und die Frage der Durchbrechung der Bestandskraft, Betriebs-Berater (BB) 2005, 131 et seq.

Eicker, Klaus / Obser, Ralph, Die Kapitalverkehrsfreiheit bekommt Konturen: zugleich Anmerkungen zu den Schlussanträgen in den Rechtssachen Weidert und Paulus, Manninen und Lenz, Internationales Steuerrecht (IStR) 2004, 443 et seq.

Eicker, Klaus / Obser, Ralph, Lasertec Shows ECJ Reluctance, International Tax Review 2007, 23

Eilers, Stephan, Gemeinschaftsrechtliche Anwendungsrestriktionen für § 42 AO, Der Betrieb (DB) 1993, 1158

Eimermann, Dieter, OECD-Arbeiten zum schädlichen Steuerwettbewerb - ein Zwischenstand, Internationales Steuerrecht (IStR) 2001, 81 et seq.

Elton, Edwin J. / Gruber, Martin J. / Agrawal, Deepak / Mann, Christopher, Explaining the Rate Spread on Corporate Bonds, Journal of Finance, February 2001, 247 et seq.

Emiliou, Nicolas, The Principle of Proportionality in European Law, A Comparative Study, Kluwer Law International, London / The Hague / Boston 1996

Emmeluth, Christian, Denmark Enacts New CFC Regime with Amendments, International Tax Report 1995, 1 et seq.

Emmeluth, Christian, Denmark Sets Up New CFC Law and Anti-Avoidance Measures, International Tax Report 1995, page 5 et seq.

Emmeluth, Christian, Host Country Denmark, Tax Planning International Forum (September) 2000

Emmeluth, Christian, New Provisions Concerning the Taxation of Danish Holding Companies, EC Tax Journal 1999, 103 et seq.

Emmeluth, Christian, Taxation of Global Operations Conducted Through a Tax Haven Subsidiary, Tax Planning International Forum, Host Country Denmark (December) 2004

Engel, Dietmar / Hammerschmidt, Lars, Die Bedeutung der Rechtssache Manninen für die deutsche Besteuerungspraxis, Internationales Steuerrecht (IStR) 2005, 405 et seq.

Engelen, Frank A., Interpretation of Tax Treaties under International Law. A Study of Articles 31, 32, and 33 of the Vienna Convention on the Law of Treaties and their Application to Tax Treaties, IBFD Doctoral Series, Volume 7, IBFD Publications, Amsterdam 2004

Engelschalk, Michael / Flick, Hans, Steuern auf ausländische Einkünfte, Münchener Schriften zum Internationalen Steuerrecht, C.H. Beck, München 1985

Englisch, Joachim, Einige Schlussfolgerungen zur Grundfreiheitskompatibilität des § 1 AStG - zugleich Anmerkungen zum Urteil des EuGH in der Rs. *SGI,* Internationales Steuerrecht (IStR) 2010, 139 et seq.

Englisch, Joachim, EuGH Entscheidung: Besteuerung der Gewinne bei der Muttergesellschaft unter Ausschluss gebietsfremder Tochtergesellschaften - Anmerkungen, Internationales Steuerrecht (IStR) 2010, 213 et seq.

Englisch, Joachim, Fiscal Cohesion in the Taxation of Cross-Border Dividends (Part One), European Taxation 2004, 323 et seq.

Englisch, Joachim, Fiscal Cohesion in the Taxation of Cross-Border Dividends (Part Two), European Taxation 2004, 355 et seq.

Englisch, Joachim, Reform of the Reorganisation Tax Act and Related Changes, European Taxation 2007, 339 et seq.

Englisch, Joachim, The European Treaties' Implications for Direct Taxes, Intertax 2005, 310 et seq.

Ernst & Young, Country Survey Finland, January 2002

Ernst & Young, EU Tax News May / June 2007, 8 et seq.

Ernst & Young, Sweden's Council for Advance Tax Rulings Upholds Controlled Foreign Corporation Legislation, Tax & Legal Flash 2005, Document Number TLF 2005/339

Ernst &Young International Tax Alert, Swedish Tax Agency Proposes Amendments to CFC Legislation, May 7, 2010

Ernst &Young International Tax Services, International Tax Update: Finance Bill 2011, December 2010

Estoile-Campi, Agnes, Waterloo, morne plaine: l'article 209 B après l'arret Schneider, Revue de Jurisprudence Fiscale 2003, 113-114

European Commission Issues Formal Notice to France on Application of French CFC Rules to Luxembourg Captive Insurance Companies, Tax News Service (TNS), 29/2002, July 9, 2002

Evans, David / Delahunty, Liam, E.U. Perspective on U.K. CFC Rules, Tax Planning International Review 2007, 15 et seq.

Evans, David / Delahunty, Liam, ECJ Decision: Cadbury Schweppes and the U.K. CFC Rules, Tax Planning International Review 2006, 11 et seq.

Farmer, Paul, Taxable Persons and the 'Private Life' of Companies, EC Tax Journal 1997, 41 et seq.

Favi, Linda, National Report Italy, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 349 et seq.

Fédération des Experts Comptables Européens (FEE), FEE Position Paper on Controlled Foreign Company Legislations in the EU, April 2002

Feria de la, Rita, Prohibition of Abuse of (Community) Law: The Creation of a New General Principle of EC Law through Tax, Common Market Law Review 2008, 432

Feria de la, Rita, When do Dealings in Shares Fall within the Scope of VAT?, EC Tax Review 2008, 24 et seq.

Ferrol, M. / Queiroli, G., Italy's CFC Rules Applicable to EU Companies, Tax Administration Says, Tax Notes International 2006, 269

Fisher, Irving, The Purchasing Power of Money: Its Determination and Relation to Credit, Interest, and Crises, assisted by Harry G. Brown, Macmillan, New York 1922

Fisher, Irving, The Theory of Interest: As Determined by Impatience to Spend Income and Opportunity to Invest It, Macmillan, New York 1930

Fleming, Clifton J. Jr. / Peroni, Robert J. / Shay, Stephen E., Fairness In International Taxation: The Ability-To-Pay Case For Taxing Worldwide Income, Florida Tax Review 2001, 299 et seq.

Flick, Hans / Wassermeyer, Franz / Baumhoff, Hubertus, Außensteuerrecht, Kommentar, O. Schmidt, Köln 2003

Flick, Hans, Die Begrenzung der Fiskalsouveränität, Internationale Wirtschafts-Briefe (IWB) 1964, Fach 2, 131

Fock, Till-Henning, Sitztheorie im deutschen internationalen Steuerrecht nach der Centros-Entscheidung, Recht der Internationalen Wirtschaft (RIW) 2000, 42 et seq.

Fontana, Renata, Direct Investments and Third Countries: Things are Finally Moving… in the Wrong Direction, European Taxation 2007, 431 et seq.

Fontana, Renata, ECJ concludes German Thin Cap Legislation compatible with EC Law with respect to Third States: Lasertec, Tax Planning International European Tax Service, June 2007

Förster, Guido, CFC Legislation in Germany, Intertax 2004, 476 et seq.

Foster, Hartley, Does the ECJ Still Keep the Taxman Away?, Tax Journal, 2006, 9 et seq.

Foster, Hartley, ECJ Ruling Favours Taxpayer, Lawyer 2006, 8

France - Concept of "Non-Cooperative Jurisdiction" Added to Anti-Tax Haven Rules, KPMG Tax News Flash-Europe, no. 2010-04, January 21, 2010

Franck, Jens-Uwe, § 20 Abs. 2 AStG auf dem Prüfstand der Grundfreiheiten - Anmerkung zu den Schlussanträgen des Generalanwalts Mengozzi in der Rechtssache C-298/05 (*Columbus*), Internationales Steuerrecht (IStR) 2007, 489 et seq.

French CFC Legislation Incompatible with France-Switzerland Tax Treaty, Tax Notes International 2001, 591

French Conseil d' Etat Decision on Tax Treaty Overriding CFC Legislation, Tax Analysts Tax Document Service 2002, Doc. 2002 - 15798

French Supreme Court holds French CFC Legislation Incompatible with Treaties in Case Regarding France-Switzerland treaty, Tax News Service (TNS), 28/2002, July 2, 2002

French Tax Code Incompatible with France-Switzerland Tax Treaty, Tax Notes International 2001, 211

French Tax Review: Tax Treaties Trump French CFC Law, Court Reaffirms, Tax Notes International 2003, 1011

Friel, Daniel, National Report UK, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 869 et seq.

Frisch, Daniel J., The Economics of International Tax Policy: Some Old and New Approaches, Tax Notes International, April 30, 1990, 18 et seq.

Frischmuth, Markus, Bestandsaufnahme und Zukunft der deutschen Hinzurechnungsbesteuerung (Par. 7 bis 14 AStG), Internationales Steuerrecht (IStR) 2005, 361 et seq.

Frobert, Thomas, Danish Official Proposes New Rules on CFC Taxation, Tax Analysts Tax Document Service 2001, Doc. 2001-28851

Galhardo, L. Rosanova / Lopes, J. Ney de Figueirédo (Jr.), Brazilian CFC rules: Current Trends, Government Overreaching, Journal of International Taxation 2007, 38 et seq.

Galli, Carlo, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Italy, International Transfer Pricing Journal 2008, 44 et seq.

Gandenberger, Otto, Kapitalexportneutralität *versus* Kapitalimportneutralität, 7 Aufsätze zur Wirtschaftspolitik, Forschungsinstitut für Wirtschaftspolitik an der Universität Mainz, Mainz 1983

Garrido, Alfonso, Anti-Avoidance Provisions in the Spanish Corporate Income Tax Act, Tax Planning International Review 2003, 10 et seq.

Gassner, Wolfgang / Lang, Michael / Lechner, Eduard, Der Entwurf eines österreichischen Außensteuergesetzes - Grenzen der Gestaltung , Linde Verlag, Vienna 2001

Gassner, Wolfgang, Neun und noch viel mehr Gründe gegen ein österreichisches Außensteuergesetz, Steuer und Wirtschaft International (SWI) 2001, 295 et seq.

Gazzo, Massimiliano, Italy's CFC Legislation Implemented and Participation Exemption Extended, Bulletin for International Fiscal Documentation 2002, 77 et seq.

Gelin, S., Taxation of Global Operations Conducted Through a Tax Haven Subsidiary, Tax Planning International Forum, Host Country France, (December) 2004

Gersbach, Hans / Lipponer, Alexander, Firm Defaults and the Correlation Effect, European Financial Management, Volume 9, 361 et seq.

Gershuny, Philip / Israel, Herve / Borzumato, Domenico / Dörr, Ingmar, Impact of Cadbury Schweppes on CFC Legislation, Tax Planning International Review, (January) 2007

Geyrhalter, Volker, Niederlassungsfreiheit contra Sitztheorie - Good Bye "Daily Mail"?, Europäisches Wirtschafts- und Steuerrecht (EWS) 1999, 201 et seq.

Giuliani, Marco, CFC Loopholes Can Still Benefit Italian Taxpayers, International Tax Review, 2002, 38 et seq.

Giuliani, Marco, Italy Introduces CFC legislation, World Tax Adviser, February 2002

Giuliano, Stefano, National Report Italy, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 615 et seq.

Gliniorz, Sven / Klattig, Matthias, Das Ende der deutschen Hinzurechnungsbesteuerung?, Neue Wirtschafts-Briefe (NWB) 2006, Fach 2, 9073 et seq.

Goebel, Sören / Haun, Jürgen, Par. 4h EStG und Par. 8a KStG (Zinsschranke) in der Hinzurechnungsbesteuerung, Internationales Steuerrecht (IStR) 2007, 768 et seq.

Goebel, Sören / Palm, Annette, Der Motivtest - Rettungsanker der deutschen Hinzurechnungsbesteuerung?, Internationales Steuerrecht (IStR) 2007, 720 et seq.

Gorringe, Jason, OECD Member States Tighten Up Their CFC Rules, Tax News International, April 11, 2001

Gosch, Dietmar, Anrechnung ausländischer Steuern nach dem EuGH-Urteil in der Rechtssache “Manninen” trotz Bestandskraft?, Deutsches Steuerrecht (DStR) 2004, 1988 et seq.

Göttsche, Max, Das Centros-Urteil des EuGH und seine Auswirkungen, Deutsches Steuerrecht (DStR) 1999, 1403 et seq.

Goulard, Guillaume / Jolly, Guillaume, French Lawmakers Revisit CFC Rules, Tax Notes International 2005, 219 et seq.

Gouthière, Bruno, French Anti-Abuse International Tax Legislation: Recent Developments, European Taxation 2006, 514 et seq.

Gouthière, Bruno, Overview of the French CFC Legislation, European Taxation 2008, 50 et seq.

Graf, H. / Bisle, M., Reaktion der deutschen Finanzverwaltung auf das EuGH-Urteil in Sachen Cadbury Schweppes, Die Information über Steuer und Wirtschaft (INF) 2007, 342 et seq.

Green, Robert A., The Future of Source-Based Taxation of the Income of Multinational Enterprises, Volume 79, Cornell Law Review 1993, 18 et seq.

Groeben von der, Hans / Schwarze, Jürgen, Kommentar zum Vertrag über die Europäische Union und zur Gründung der Europäischen Gemeinschaft, Kommentar, 6. Auflage, Nomos Verlagsgesellschaft, Baden-Baden 2003

Groeben von der, Hans / Thiesing, Jochen / Ehlermann, Claus-Dieter, Kommentar zum EU-/EG-Vertrag, 5. Auflage, Nomos Verlagsgesellschaft, Baden-Baden 1997

Grotherr, Siegfried, Erneute Reform der Hinzurechnungsbesteuerung durch das Unternehmensteuerfortentwicklungsgesetz (Teil 2), Internationale Wirtschafts-Briefe (IWB) 2002, Fach 3, Gruppe 1, 417 et seq.

Grotherr, Siegfried, Verzicht auf eine Hinzurechnungsbesteuerung bei ausländischen Umwandlungen nach dem SEStG, Internationale Wirtschafts-Briefe (IWB) 2007, Fach 3, Gruppe 1, 179 et seq.

Grünbaum, Jan, Finland: CFC Rules to be Revised, Tax News Service (TNS) 1998, 376

Grünbaum, Jan, Finland: Guidance on CFC Rules and Court Ruling, Tax News Service (TNS) 1999, 215

Grünbaum, Jan, Finland: Revised CFC Rules Enacted, Tax News Service (TNS) 1999, 7

Gustafson, Charles H. / Peroni, Robert J. / Pugh, Richard Crawford, Taxation of International Transactions: Materials, Text and Problems, West Pub. Co., St. Paul 1997

Gutmann, Daniel / Danon, Robert / Salome, Hugues, French-Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law, Intertax 2003, 156 et seq.

Gutmann, Daniel, France: The *Rimbaud* and *Prunus* Cases, in: Lang, Michael / Pistone, Pasquale / Schuch, Josef / Staringer, Claus / Storck, Alfred (eds.), ECJ - Recent Developments in Direct Taxation 2010, Series on International Tax Law, Michael Lang (ed.), Volume 67, Linde Verlag, Vienna 2011, 89 et seq.

Gutmann, Daniel, L'article 209B du code général des impots : le début de la fin?, Dr. 21, 2001, ER 018

Gutmann, Daniel, Taxation of Groups of Companies: Lessons to be Drawn from *Oy AA*, Tax Planning International European Tax Services, February 2008

Haase, Florian, Grenzüberschreitende Sitzverlegungen von Kapitalgesellschaften vor und nach dem Urteil des EuGH vom 5.11.2002 (Rs. Überseering), Internationale Wirtschafts-Briefe (IWB) 2003, Fach 11, Gruppe 2, 529 et seq.

Haase, Florian, Die atypisch stille Gesellschaft in der Hinzurechnungsbesteuerung, Internationales Steuerrecht (IStR) 2008, 312 et seq.

Habers, Frederik, New Dutch Tax Legislation Precursor to Favourable 2007 Corporate Income Tax Reforms, Tax Planning International Review 2006, 19 et seq.

Hackemann, Tim, Kann die Niederlassungsfreiheit vor der Hinzurechnung von Drittlandseinkünften nach dem AStG Hahn, Hartmut, Bemerkungen zum EuGH-Urteil "Cadbury Schweppes", Internationales Steuerrecht (IStR) 2006, 667 et seq.

Hahn, Hartmut, Im Westen nichts Neues, Überlegungen zur Entscheidung des EuGH in der Rechtssache *Papillon*, Internationales Steuerrecht (IStR) 2009, 198 et seq.

Hahn, Hartmut, Par. 175 Abs. 2 AO n. F. und das EuGH-Urteil in der Rechtssache Manninen: ein Lehrstück darüber, wie man es nicht macht, Internationales Steuerrecht (IStR) 2005, 145 et seq.

Hamacher, Rolfjosef / Hahne, Klaus D., Aspekte der Anrechnung von Körperschaftsteuern auf ausländische Dividendenerträge: Auswirkungen des EuGH-Urteils vom 7.9.2004 Rs. C-319/02, Manninen, Der Betrieb (DB) 2004, 2386 et seq.

Hans, Adrian, Hinzurechnungsbesteuerung und phasengleiche Aktivierung von Dividendenansprüchen: Die faktische Abschaffung der Hinzurechnungsbesteuerung?, Internationale Wirtschafts-Briefe (IWB) 2003, Fach 3, Gruppe 1, 1151 et seq.

Hansen, A. O., Denmark: Holding Company Regime Amendments, European Taxation 2001, 229 et seq.

Hansson, Asa / Nilsson, Caroline, Sweden: Government Proposes New CFC Rules, Tax Notes International 2003, 998

Hardwick, Michael / Bouwer, Clare, Plus Ca Change…? Full Reform of the Controlled Foreign Company Rules, Linklaters UK Tax Alert, July 1, 2011

Hardy, U.K. Proposes Amendment to CFC Excluded Countries List, Tax Notes International 1998, 286 et seq.

Haslehner, Werner, Das Konkurrenzverhältnis der Europäischen Grundfreiheiten in der Rechtsprechung des EuGH zu den direkten Steuern, Internationales Steuerrecht (IStR) 2008, 565 et seq.

Haslinger, Katharina, National Report Austria, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 73 et seq.

Hasse, Florian, Germany's CFC Regulations - An Overview, Tax Analysts Tax Document Service 2002, Doc 2002-15631

Haun, Jürgen / Käshammer, Daniel / Reiser, Hagen, Das BMF-Schreiben vom 8.1.2007 zur Hinzurechnungsbesteuerung - eine erste Analyse, GmbH-Rundschau (GmbHR) 2007, 184 et seq.

Helminen, Marjaana, Amendments to Finland's CFC Regime, Bulletin for International Taxation 2009, 163 et seq.

Helminen, Marjaana, Dividend Equivalent Benefits and the Concept of Profit Distribution of the EC Parent-Subsidiary Directive, EC Tax Review 2000, 161 et seq.

Helminen, Marjaana, Finnish Government Proposes Changes to New CFC Regime, Tax Notes International 1998, 1431

Helminen, Marjaana, Finnish Parliament Approves Amendments to CFC Regime, Tax Notes International 1999, 343

Helminen, Marjaana, Finnish Tax Board Releases CFC Blacklist, Tax Notes International 1999, 2317

Helminen, Marjaana, Is There a Future for CFC-Regimes in the EU?, Intertax 2005,117 et seq.

Helminen, Marjaana, National Report Finland, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 191 et seq.

Helminen, Marjaana, The Dividend Concept in International Tax Law - Dividend Payments between Corporate Entities, Series on International Taxation, Kluwer Law International, London 1999

Helminen, Marjaana, The *Esab* Case (C-231/05) and the Future of Group Taxation Regimes in EU, Intertax 2005, 595 et seq.

Helvoirt van, Joost, Niederlande: Anwendungschreiben Schachtelprivileg, Internationales Steuerrecht (IStR) 2008, Länderbericht, 32-33

Hemels, Sigrid / Rompen, Joost / Smet, Patrick / De Waele, Isabelle / Adfeldt, Steffan / Breuninger, Gottfried / Ernst, Markus / Carpentier, Viviane / Mostafavi, Siamak, Freedom of Establishment or Free Movement of Capital: Is There an Order of Priority? Conflicting Visions of National Courts and the ECJ, EC Tax Review 2010, 19 et seq.

Herbert Smith, New Controlled Foreign Company ("CFC") Rules, French Tax Briefing, January 2005, 6

Herzig Norbert / Wagner, Thomas, Die Besteuerung von Auslandsengagements spanischer Holdinggesellschaften: Erweitertes Holdingprivileg, Hinzurechnungsbesteuerung und Gestaltungsmöglichkeiten, Internationales Steuerrecht (IStR) 2003, 225 et seq.

Hill, D., The CFC Regime: Restricting EU Fundamental Freedoms? Financial Instruments Tax and Accounting Review (FITAR) 2005, page 1 et seq.

Hinds, Upstream Attribution of Income and Gains and Double Tax Treaty Relief: Some Implications of the Bricom Decision, EC Tax Journal 1997, 162

Hintsanen, Lari /Pettersson, Kennet, The Implications of the ECJ Holding the Denial of Finnish Imputation Credits in Cross-Border Situations to be Incompatible With the EC Treaty in the Manninen Case, European Taxation 2005, 130 et seq.

HM Revenue & Customs, Draft Guidance - Changes to Controlled Foreign Companies Rules, London, December 6, 2006

HM Treasury / HM Revenue & Customs, Taxation of the Foreign Profits of Companies: A Discussion Document, London, June 2007

HM Treasury / HM Revenue & Customs, CFC Interim Improvements - Consultation Draft, London, 2010

HM Treasury / HM Revenue & Customs, Consultation on Controlled Foreign Companies (CFC) Reform, London, June 30, 2011

Hoenjet, Francois, The Leur-Bloem Judgement: The Jurisdiction of the European Court of Justice and the Interpretation of the Anti-Abuse Clause in the Merger Directive, EC Tax Review 1997, 206 et seq.

Hohenwarter, Daniela / Plansky, Patrick, Die Kapitalverkehrsfreiheit mit Drittstaaten im Lichte der Rechtssache Holböck, Steuer und Wirtschaft International (SWI) 2007, 346 et seq.

Hohenwarter, Daniela, The Allocation of Taxing Rights in the Light of the Fundamental Freedoms of EC Law, in: Tax Treaty Law and EC Law, Lang, Michael / Schuch, Josef / Staringer, Claus (eds.), Linde Verlag, Vienna 2007, page 83 et seq.

Honda, Mitsuhiro / Ault, Hugh J., Japanese CFC Rules Consistent With Treaty, Court Holds, Tax Notes International 2008, 875 et seq.

Hosson de, Fred C., The Direct Investment Tax Initiatives of the European Community, Kluwer Law and Taxation Publishers, Deventer / Boston 1990

Hosson de, Fred C., The Parent-Subsidiary Directive, Intertax 1990, 414 et seq.

Hufbauer, Gary Clyde, assisted by Joanna M. van Rooij, U.S. Taxation of International Income, Blueprint For Reform, Institute For International Economics, Washington, D.C. 1992

Hughes, David, Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes), Bulletin for International Fiscal Documentation 1999, 13 et seq.

Hughes, David, The U.K.'s Controlled Foreign Companies Legislation: A Very Real Threat, Tax Notes International 2000, 2527 et seq.

Hull, John / White, Alan, Valuing Credit Default Swaps I: No Counterparty Default Risk, Journal of Derivatives, Toronto 2000, 29 et seq.

Hull, John / White, Alan, Valuing Credit Default Swaps II: Modeling Default Correlations, Journal of Derivatives, Toronto 2001, 12 et seq.

Hume, A. / Seinsche, G., Court Demands CFC Rules Rethink, International Tax Review 2006, 27 et seq.

Hume, A., Cadbury Schweppes - Implications for U.K. Corporates, Tax Planning International Transfer Pricing 2006, 23 et seq.

IBFD, Corporate Tax in Depth Study (Denmark) 2002, 154

IBFD, Corporate Tax Summary (Denmark) 2002, 19

IBFD, Corporate Tax Summary (Finland) 2002, 16

IBFD, Denmark: Changes Proposed to Taxation Inbound / Outbound Dividends and CFC Taxation; Tax News Service (TNS) 1999, 14 et seq.

IBFD, Denmark: Corporate Income Tax Amendments Approved by Parliament, Tax News Service (TNS) 2002, 425

IBFD, Denmark: New Regime for Dividend Taxation Enacted, Tax News Service (TNS) 1999, 67

IBFD, Denmark: Proposed Corporate and Individual Income Tax Amendments, Tax News Service (TNS) 2002, 153

IBFD, France: Amendment to CFC Legislation Passed; Tax News Service (TNS) 1993, 28

IBFD, France: CFC Provisions Apply to Captive Insurance Companies, Tax News Service (TNS) 1995, 3

IBFD, France: Controlled Foreign Corporation Legislation to be Tightened, Tax News Service (TNS) 1992, 344 et seq.

IBFD, France: Guideline on Application of CFC Legislation, Tax News Service (TNS) 1998, 208 et seq.

IBFD, Italy: “Black” List for Anti-Tax Haven Rules Modified, Tax News Service (TNS) 2002, 230

IBFD, Italy: CFC Legislation Implemented, Tax News Service (TNS) 2001, 606 et seq.

IBFD, Italy: Clarifications Given on Law Accompanying the Finance Law for 2000, Tax News Service (TNS) 2001, 124

IBFD, Italy: Revised CFC Legislation Proposed, Tax News Service (TNS) 2000, 189 et seq.

IBFD, Italy: Rulings on Safe Haven Provisions for CFC Purposes, Tax News Service (TNS) 2002, 576

IBFD, Sweden: Bill to Add New Countries to CFC “White List”, Tax News Service (TNS) 1998, 403 et seq.

IBFD, Sweden: Offshore Rules Tightened, Tax News Service (TNS) 1996, 34 et seq.

IBFD, Sweden: Sweden Gets Tough on Offshore Companies, Tax News Service (TNS) 1996, 180

IBFD, United Kingdom: Controlled Foreign Companies, Tax News Service (TNS) 1999, 72

Innamorato, Caterina, An Unwritten Anti-Abuse Principle in the Italian Tax System, European Taxation 2008, page 449 et seq.

Intemann, Jens, Das Körperschaftsteueranrechnungsverfahren auf dem Prüfstand des EuGH: Anrechnung ausländischer Körperschaftsteuer nach der Manninen-Entscheidung, Neue Wirtschafts-Briefe (NWB) 2005, 4955 et seq.

International Financial Reporting Standards IRFS, IDW Textausgabe, IDW Verlag, Düsseldorf 2009

International Institute for Management Development (IMD), World Competitiveness Yearbook, Lausanne 2000

Ippolito, Alexandre / Pontnau-Faure, Emmanuelle, France: CFC Rules Reform, Tax Planning International Transfer Pricing 2005, 10

IWB Kurznachrichten, Ungarn: Steuerreform 2008 für Körperschaften, Internationale Wirtschafts-Briefe (IWB) 2007, Fach 1, 1218

Jiménez, Adolfo J. Martin, Transfer Pricing and EU Law Following the ECJ Judgement in *SGI*: Some Thoughts on Controversial Issues, Bulletin for International Taxation 2010, 271 et seq.

Jimenez, Natalie Halla-Villa, Spanien: Jüngste Gesetzesänderungen zur Hinzurechnungsbesteuerung, Unterkapitalisierungsregelung und grenzüberschreitende Lizenzzahlungen, Internationales Steuerrecht (IStR) 2004, Länderbericht, 3

Joseph, A., Changes to Controlled Foreign Company Rules, Derivatives and Financial Instruments 2008, 102 et seq.

Juilhard, P., Corporate Income Tax: Recent Developments in the French Territorial Approach, Bulletin for International Fiscal Documentation 1995, 107 et seq.

Juusela, Janne, Finland: An Amendment to the CFC Legislation, EC Tax Review 1999, 88

Juusela, Janne, National Report Finland, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 479 et seq.

Kabbaj Hicham / Raingeard de la Bletière, Emmanuel, National Report France, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 221 et seq.

Kämper, Andrea, “Eurowings”: EU-Rechtsverstöße bei der gewstl. Hinzurechnungsbesteuerung, dem AStG und der Gesellschafterfremdfinanzierung!, Finanz-Rundschau (FR) 2001, 665 et seq.

Kaufmann, Robert, Controlled Foreign Companies (CFC)-Gesetzgebung - Übersicht über die Rechtslage in den EU-Mitgliedstaaten, Steuer und Wirtschaft International (SWI) 2001, 16 et seq.

Kemmeren, Eric C.C.M., ECJ Should Not Unbundle Integrated Tax Systems!, EC Tax Review 2008, page 4 et seq.

Kemmeren, Eric C.C.M., Principle of Origin in Tax Conventions: A Rethinking of Models, Pijnenburg, Dongen 2001

Kemmeren, Eric C.C.M., The Internal Market Approach Should Prevail over the Single Country Approach, in: Luc Hinnekens and Philippe Hinnekens (eds.), A Vision of Taxes Within and Outside European Borders. Festschrift in Honour of Prof. Dr. Frans Vanistendael, Kluwer Law International, The Hague 2008, 555 et seq.

Kempf , Andreas / Straubinger, Peter, Nochmals: Die EU-Zins- / Lizenzrichtlinie und § 8 Nr. 1 GewStG, Internationales Steuerrecht (IStR) 2005, 773 et seq.

Kessler, Wolfgang / Becker, Jan Dierk, Die atypisch stille Gesellschaft als Finanzierungsalternative zur Reduzierung der Steuerbelastung aus der Hinzurechnungsbesteuerung, Internationales Steuerrecht (IStR) 2005, 505 et seq.

Kessler, Wolfgang / Eicke, Rolf, The Egg of Columbus Container: German Buget Sunny Side Up, Not Scrambled, Tax Notes International 2008, 587 et seq.

Kessler, Wolfgang / Eicker, Klaus / Schindler, Jörg, Hinzurechnung von Dauerschuldzinsen nach § 8 Nr. 1 GewStG verstößt gegen die Zins- / Lizenzgebühren-Richtlinie, Internationales Steuerrecht (IStR) 2004, 678 et seq.

Kessler, Wolfgang / Jehl, Melanie, Kritische Analyse der Zentralfunktion des Stammhauses, Internationale Wirtschafts-Briefe (IWB) 2007, Fach 10, Gruppe 2, 1977 et seq.

Kiekebeld, B.J. / Merks, P.F.E.M. / Smit, D.S., Cadbury Schweppes: analyse en de gevolgen voor de fiscale behandeling van buitenlandse concernfinanciering onder de huidige Wet VPB 1969, Weekblad Fiscaal Recht 2007, 129 et seq.

Killius, Jürgen, Taxation of Global Operations Conducted Through a Tax Haven Subsidiary, Tax Planning International Forum, Host Country Germany, (December) 2004

Kinnegim, Godfried, Netherlands: Year in Review, Tax Notes International 2006, 1082 et seq.

Kirchmayr , Sabine/ Lechner, Eduard, Highlights aus dem Workshop „Update - internationales Steuerrecht“, Österreichisches Recht der Wirtschaft 2007, 626 et seq.

Kirkell, Sarah, EU Commission Should Act to Remove CFC Barriers Between Member States, Accountancy Group Warns, Tax Analysts Tax Document Service 2002, Doc 2002-13542

Knobbe-Keuk, Brigitte, Die Niederlassungsfreiheit: Diskriminierungs- oder Beschränkungsverbot?, Der Betrieb (DB) 1990, 2573 et seq.

Koehlmark , Anders/ Kaellqvist, Jan, New CFC Legislation in Sweden, Bulletin for International Fiscal Documentation 2004, 225 et seq.

Kofler, Georg W., Die steuerliche Abschirmwirkung ausländischer Finanzierungsgesellschaften und ihr Durchbrechung aus österreichischer Sicht, Schriftenreihe zum Internationalen Steuerrecht, Michael Lang (ed.), Linde Verlag, Vienna 2002

Köhler, Stefan / Eicker, Klaus, Kritische Anmerkungen zum BMF-Schreiben „*Cadbury Schweppes*“ v. 8.1.2007, Deutsches Steuerrecht (DStR) 2007, 331 et seq.

Köhler, Stefan / Tippelhofer, Martina, Kapitalverkehrsfreiheit auch in Drittstaatenfällen? Zugleich Anmerkung zu den Entscheidungen des EuGH in den Rechtssachen *Lasertec* (C-492/04) und *Holböck* (C-157/05) sowie zum BMF-Schreiben v. 21.3.2007 (IV B 7 – G 1421/0), Internationales Steuerrecht (IStR) 2007, 645 et seq.

Kohnhorst, Kai-Uwe, Konzerninterne Finanzierungsgesellschaften vor der Hinzurechnungsbesteuerung, Tectum Verlag, Marburg 2002

Kollruss, Thomas, Fiktive Anrechnung ausländischer Steuern im System der neuen Hinzurechnungsbesteuerung: lässt sich die Hinzurechnung durch Gewinnausschüttungen der ausländischen Zwischengesellschaft vermeiden?, Internationales Steuerrecht (IStR) 2006, 513 et seq.

Kollruss, Thomas, Hinzurechnungsbesteuerung bei doppelt ansässigen Kapitalgesellschaften, Internationales Steuerrecht (IStR) 2008, 316 et seq.

Köplin, Manfred / Sedemund, Jan, Das BMF-Schreiben vom 8.1.2007 - untauglich, die EG-Rechtswidrigkeit der deutschen Hinzurechnungsbesteuerung nach *Cadbury Schweppes* zu beseitigen!, Betriebs-Berater (BB) 2007, 244 et seq.

Korf, Ralph, EuGH-Entscheidungen, Abziehbarkeit von Betriebsstättenverlusten aus Drittstaaten, Internationales Steuerrecht (IStR) 2008, 107 et seq.

Körner, Andreas, Europarecht und CFC-Regelungen: Anrufung des EuGH im Verfahren “*Cadbury Schweppes*”, Internationales Steuerrecht (IStR) 2004, 697 et seq.

Körner, Andreas, German Reference to the ECJ for a Preliminary Ruling: Unilateral Switch-Over Clause and CFC Rules, Intertax 2006, 32 et seq.

KPMG Tax News Flash-Europe, Sweden: Proposal to Change the CFC Rules Would Impose Additional Restrictions Concerning “the White List”, no. 2010-24, May 19, 2010

KPMG’s EU Tax Centre, ECJ *Truck Center* case (C-282/07) - Decision, Tax Planning International European Tax Service, January 23, 2009

Kraft , Gerhard/ Bron, Jan Frederik, Deutsche Hinzurechnungsbesteuerung und Europarecht - Eine Analyse vor dem Hintergrund aktueller Entwicklungen, Recht der Internationalen Wirtschaft (RIW) 2006, 209 et seq.

Kraft, Gerhard / Bron, Jan Frederik, Implikationen des Urteils in der Rechtssache “*Cadbury Schweppes*” für die Fortexistenz der Deutschen Hinzurechnungsbesteuerung, Internationales Steuerrecht (IStR) 2006, 614 et seq.

Kramer, Jörg-Dietrich, German CFC Legislation’s Tax Haven Trapdoor, Tax Notes International 2005, 619 et seq.

Kriegbaum, Knud Erik, Denmark Changes Ground Rules on International Taxation, Tax Planning International 1995, 10 et seq.

Kriegbaum, Knud Erik, Denmark Tightens CFC Taxation Once More!, Tax Planning International Review 2001, 9 et seq.

Krogmann , Catherin / Vitale, Andrea, Kritische Würdigung des BMF-Schreibens zu „Cadbury Schweppes“, Internationale Wirtschafts-Briefe (IWB) 2007, Fach 3, Gruppe 1, 2243 et seq.

Kroppen, Heinz-Klaus / Hagemeier, Timo, Hinzurechnungsbesteuerung bei neuen Vertriebsstrukturen, Internationale Wirtschafts-Briefe (IWB) 2004, Fach 3, Gruppe 2, 803 et seq.

Kussmaul, Heinz / Ruiner, Christoph, Ausgewählte Charakteristika der Limited mit ausschließlicher Geschäftstätigkeit in Deutschland im Licht der aktuellen Gesetzesänderungen, Internationales Steuerrecht (IStR) 2007, 696 et seq.

Lando, David, Credit Risk Modeling: Theory and Applications, Princeton Series in Finance, Princeton University Press, Princeton / Oxford, 2004

Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004

Lang, Michael / Pistone, Pasquale / Schuch, Josef / Staringer, Claus / Storck, Alfred (eds.), ECJ - Recent Developments in Direct Taxation 2010, Series on International Tax Law, Michael Lang (ed.), Volume 67, Linde Verlag, Vienna 2011

Lang, Michael / Schuch, Josef / Staringer, Claus, ECJ - Recent Developments in Direct Taxation, EUCOTAX Series on European Taxation, Linde Verlag, Vienna 2006

Lang, Michael, CFC Legislation and Community Law, European Taxation 2002, 374 et seq.

Lang, Michael, CFC-Gesetzgebung und Gemeinschaftsrecht, Internationales Steuerrecht (IStR) 2002, 217 et seq.

Lang, Michael, CFC-Regelungen und Doppelbesteuerungsabkommen, Internationales Steuerrecht (IStR) 2002, page 717 et seq.

Lang, Michael, CFC-Regulations and Double Taxation Treaties, Bulletin for International Fiscal Documentation 2003, 51 et seq.

Lang, Michael, Die Beschränkung der zeitlichen Wirkung von EuGH-Urteilen im Lichte des Urteils *Meilicke*, Internationales Steuerrecht (IStR) 2007, 235 et seq.

Lang, Michael, Die Zukunft der Doppelbesteuerungsabkommen im Lichte von Columbus Container, in: Festschrift für Wolfram Reiss: zum 65. Geburtstag, O. Schmidt, Köln 2008, 679 et seq.

Lang, Michael, in: Abusive Application of International Tax Agreements, Proceedings of a Seminar held in Munich in 2000 during the 54th Congress of the International Fiscal Association, Chair: Prof. Peter Essers, Kluwer Law International, The Hague 2001

Lang, Michael, Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions, EC Tax Review 2009, 98 et seq.

Lang, Michael, Rechtsmissbrauch und Gemeinschaftsrecht im Lichte von Halifax und Cadbury Schweppes, Steuer und Wirtschaft International (SWI) 2006, 273 et seq.

Lang, Michael, Seminar B, Teil 2: Das OECD-Musterabkommen - 2001 und darüber hinaus: Welche Bedeutung haben die nach Abschluss eines Doppelbesteuerungsabkommens erfolgten Änderungen des OECD-Kommentars?, Internationales Steuerrecht (IStR) 2001, 536 et seq.

Lang, Michael, The Application of the OECD Model Tax Convention to Partnerships, A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs, Linde Verlag, Vienna 2000

Laursen, Jens, Die neue dänische Holdingbesteuerung, Internationales Steuerrecht (IStR) 1999, 717 et seq.

Leclercq, Laurent, Interacting Principles: The French Abuse of Law Concept and the EU Notion of Abusive Practices, Bulletin for International Taxation 2007, 235 et seq.

Leegaard, Thor, United Kingdom: CFC Legislation - Recent Changes to the Acceptable Distribution Policy Exemption, European Taxation 2001, 293 et seq.

Lefèvre-Péaron, Patrice, French CFC Rules - New Guideline, Tax Planning International Review, 1998, 3 et seq.

Lehner, Moris, Wettbewerb der Steuersysteme im Spiegel europäischer und US-amerikanischer Steuerpolitik, Steuer und Wirtschaft (StuW) 1998, 159 et seq.

Leisner, Walter, Abkommensbruch durch Außensteuerrecht?, Recht der Internationalen Wirtschaft (RIW) 1993, 1013 et seq.

Lessambo, Felix, French CFC Legislation: The End of a Legislatively Controversial Rule, Tax Planning International Financing 2002

Lieber, Bettina / Rasch, Stephan, Mögliche Konsequenzen der Rechtssache „Cadbury Schweppes" für die deutsche Hinzurechnungsbesteuerung, GmbH-Rundschau (GmbHR) 2004, 1572 et seq.

Lieber, Bettina / Roeder, Achim, Transfer Pricing Rules for Transactions Involving Low-Tax Countries: Germany, International Transfer Pricing Journal 2007, 333 et seq.

Liebman, H.M., Ruling on Merger Directive, European Taxation 1997, 462-463

Liebman, H.M., The EU Code of Conduct vs. The Prohibition Against "State Aid," ABA Fall Meeting, Section of International Law and Practice, Brussels, October 16, 2003

Lindemann, A., Auswirkungen der EuGH-Verfahren Manninen/Meilicke für die Investmentbesteuerung, Betriebs-Berater (BB) 2005, 1931 et seq.

Lipsey, R.G. / Lancaster, K., The General Theory of Second Best, 1956, Review of Economic Studies, 11 et seq.

Liszicza, Bálint, National Report Hungary, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 303 et seq.

López, José Manuel Tejerizo, The New Spanish Corporation Income Tax, Intertax 1997, 221 et seq.

Lovell's International Tax Team, Impact of Cadbury Schweppes on CFC Legislation, Tax Planning International Review 2007, 7 et seq.

Lower Court of Lille: TA Lille 9 janvier 2003 no. 99-187: Société 3 Suisses International, Revue de Jurisprudence Fiscal 2003, 325-326

Lüdicke, Jürgen, Baars: Weigerung der Anerkennung des Vermögensteuerfreibetrags als Verletzung der Niederlassungsfreiheit, Internationales Steuerrecht (IStR) 2000, 337 et seq.

Lüdicke, Jürgen, Pending Cases Filed by German Courts I: *Kolumbus Container Services* Case, in: ECJ - Recent Developments in Direct Taxation, Linde Verlag, Vienna 2006, 163 et seq.

Lüdicke, Jürgen, Pending Cases Filed by German Courts I: The *Meilicke, CLT-UFA, Keller Holding, Lasertec, Rewe Zentralfinanz, Ritter-Coulais, Kolumbus Container Services, and Stauffer* Cases, in: ECJ - Recent Developments in Direct Taxation, EUCOTAX Series on European Taxation, Linde Verlag, Vienna 2006, 113 et seq.

Lüdicke, Jürgen, Pending Cases Filed by German Courts: The *Meilicke, Burda, Gronfeldt, Jäger, Heinrich Bauer Verlag, Rewe Zentralfinanz, Lidl Belgium, Stahlwerk Ergste Westig and Deutsche Shell* Cases, in: Lang, Michael / Schuch, Josef / Staringer, Claus, ECJ - Recent Developments in Direct Taxation 2007, Schriftenreihe zum Internationalen Steuerrecht, Linde Verlag, Vienna 2007, 47 et seq.

Lundström, Hans O., Capital Movements and Economic Integration, A Study of the Role of International Long-Term Capital Movements in International Economic Integration With Particular Reference to Europe, A.W. Sythoff, Leyden 1961

Lupo, Antonello, Reliefs from Economic Double Taxation on EU Dividends: Impact of the Baars and Verkooijen Cases, European Taxation 2000, 270 et seq.

Luuk, Jan Ole / Oesterhelt, Stefan / Winzap, Maurus, EuGH Report 4/06, Steuer Revue - Revue Fiscale 2006, 881 et seq.

Lyons, Timothy, What will the ECJ Decide Tomorrow?, British Tax Review 2006, 399 et seq.

MacLachlan, James / Fairley, John, UK Proposes Changes to Foreign Profits Taxation, International Tax Review 2007, 26 et seq.

Magnin, E. / Rautalahti, E., Finland: Finland's New Controlled Foreign Corporations Legislation, Bulletin for International Fiscal Documentation 1995, 118 et seq.

Maguire, Tom, The Cadbury Triangle - Anti-Avoidance and the ECJ, Irish Tax Review 2006, 63 et seq.

Maisto, Guglielmo The 2003 Amendments to the EC Parent-Subsidiary Directive: What's Next?, EC Tax Review 2004, 164 et seq.

Maiterth, Ralf, Die Hinzurechnungsbesteuerung gem. Par. 7 bis 14 AStG nach dem Unternehmenssteuerfortentwicklungsgesetz, Steuer und Studium 2002, 490 et seq.

Mäkelä, J., Finland, Now EU Member Seeks New Business With CFC and Dividend Laws, Journal of International Taxation 1995, 167 et seq.

Malherbe Jacques / de Monès, Sébastien / Durand, Pierre-Henri / Jacob, Friedhelm / Link, Mathias / Silvestri, Andrea / Brunello, Stefano / Sleurink, Paul / Bondrager, Jens / Canalejo Lasarte, Guillermo / Bastida Peydro, Miguel / Edge, Stephen / Storey, Oliver, Controlled Foreign Corporations in the EU after *Cadbury Schweppes*, Tax Management International Journal 2007, 607 et seq.

Marschner, Ernst, Die Freiheit des Kapitalverkehrs mit Drittstaaten: eine Analyse des EuGH-Urteils Holböck, Finanz Journal 2007, 359 et seq.

Marschner, Ernst, Missbrauch und Gemeinschaftsrecht: Das Urteil im Fall „Cadbury Schweppes“, Finanz Journal 2007, 17 et seq.

Marti, Armin / Widrig-Giallouraki, Anna-Maria, Slalomkurs um die Kapitalverkehrsfreiheit? EuGH: CFC-Regeln und Cadbury-Sweppes-Entscheid, Der Schweizer Treuhänder 2007, 121 et seq.

Martn, Taxation of Global Operations Conducted Through a Tax Haven Subsidiary, Tax Planning International Forum, Host Country Spain, (December) 2004

Mayr, Siegfried / Frei, Robert, Steuerliche Neuerungen in Italien, Internationale Wirtschafts-Briefe (IWB) 2001, Fach 5, 463 et seq.

Mayr, Siegfried, Änderungen im italienischen Steuerrecht 2007 (Teil I), Internationale Wirtschafts-Briefe (IWB) 2007, Fach 5, Gruppe 2, 559 et seq.

Mayr, Siegfried, Auswirkungen der aktuellen Steueränderungen - Neuerungen im italienischen Steuerrecht 2010, Internationale Wirtschafts-Briefe (IWB) 2010, 131 et seq.

Mayr, Siegfried, Die CFC-Gesetzgebung in Italien, in: Körperschaftsteuer Internationales Steuerrecht Doppelbesteuerung: Festschrift für Franz Wassermeyer zum 65. Geburtstag, C.H. Beck, München 2005, 595 et seq.

Mayr, Siegfried, Maßnahmen des italienischen Gesetzgebers - Die Entwicklungen des italienischen Außensteuerrechts 2010, Internationale Wirtschafts-Briefe (IWB) 2010, 670 et seq.

Mayr, Siegfried, Reform der Unternehmensbesteuerung in Italien (II), Internationale Wirtschafts-Briefe (IWB) 2003, Fach 5, Gruppe 2, 953 et seq.

Mbwa-Mboma, Marcellin N., French Tax Review: Tax Treaties Trump French CFC law, Court Reaffirms, Tax Notes International 2003,1011-1012

Mbwa-Mboma, Marcellin N., Treaty With Switzerland Overrides French CFC Legislation, French High Tax Court Confirms, Tax Analysts Tax Document Service 2002, Doc 2002-15647

Medert, Heiko K., Anmerkungen zur Körperschaftsteuer-Gutschrift nach dem EuGH-Urteil C-319/02 vom 7.9.2004 (*Manninen*), Internationales Steuerrecht (IStR) 2004, 828 et seq.

Medori, Christiano, United Kingdom to Strengthen CFC Legislation, Tax Planning International Review 2000, 11 et seq.

Meilicke, Wienand / Sedemund, Jan, Welche Steuern sind nach dem Manninen-Urteil des EuGH in Deutschland anzurechnen?, Der Betrieb (DB) 2005, 2040 et seq.

Meilicke, Wienand, Die Hinzurechnung von Dauerschuldzinsen nach § 8 Nr. 1 GewStG, Internationales Steuerrecht (IStR) 2006, 130

Meldgaard, Henrik, Denmark gets Tough on Outbound Corporate Tax Planning Structures, Intertax 1995, 447 et seq.

Meldgaard, Henrik, Denmark: Proposed Changes Regarding International Taxation, Tax News Service (TNS) 1996, 86

Menck, Thomas, Die (un)verborgene Krise des Außensteuerrechts, Anmerkungen zu einem Beitrag Franz Wassermeyers, Internationales Steuerrecht (IStR) 2001, 279 et seq.

Menck, Thomas, Rechtsmechanismus und Rechtscharakter der Zugriffsbesteuerung, Deutsche Steuer-Zeitung (DStZ) 1978, 106 et seq.

Mens van, H. / Gil Porquet, F., European Union - Current Tax Issues, European Taxation 2001, 335 et seq.

Merks, Paulus, Tax Evasion, Tax Avoidance and Tax Planning, Intertax 2006, 272 et seq.

Meussen, Gerhard T.K., Cadbury Schweppes: The ECJ Significantly Limits the Application of CFC Rules in the Member States, European Taxation 2007, 13 et seq.

Meussen, Gerhard T.K., *Columbus Container Services* - A Victory for the Member States' Fiscal Autonomy, European Taxation 2008, 169 et seq.

Meussen, Gerhard T.K., The *SGI* Case: ECJ Approves Belgian System of Selective Profit Corrections in Relation to Foreign Group Companies, European Taxation 2010, 245 et seq.

Michelsen, Aage, Tax Treaty Interpretation in Denmark, in: Lang, Michael (ed.), Tax Treaty Interpretation, EUCOTAX Series on European Taxation, Linde Verlag, Vienna 2000, 63 et seq.

Mill, John Stuart, Principles of Political Economy, Great Minds Series, Prometheus Books, New York 2004

Money Morning, Does the United States Still Deserve its "AAA" Credit Rating?, April 11, 2011

Mongan, John G. / Bussey, Clair W., Double Taxation Relief for Mixer Companies and CFCs, Tax Planning International Review 2002, 9 et seq.

Mongan, John G. / Bussey, Clair W., Managing the Ever-Changing Controlled Foreign Company Rules, Tax Planning International Review 2002, 3 et seq.

Mongan, John G. / Gordon-Brown, Michael, U.K. Budget Closes CFC Loophole, Tax Notes International 1999, 1218 et seq.

Mongan, John G. / Gordon-Brown, Michael, U.K. CFC Regime Enters Self-Assessment Era, Tax Notes International 1999, 1046 et seq.

Morgan, C. / Bird, M., Landmark Decision in the Cadbury Schweppes Case, The Tax Journal 2006, 7 et seq.

Morgan, C. / Bridges, J., Columbus Container Services, The Tax Journal 2008, 15-16

Morgan, Chris / Munro, Alastair, Under Control?: Taxation of Foreign Profits, The Tax Journal, 2007, 7 et seq.

Morgan, Chris, CFC Rules: Legality under EU Law, Offshore Red. 2006, 110

Moss, Mitchel / Gillham, George, Controlled Foreign Company Legislation and the Abuse of Law, Tax Planning International Review 2006, 3 et seq.

Mössner, Jörg Manfred / Blumenwitz, Dieter, Doppelbesteuerungsabkommen und nationales Recht, Münchener Schriften zum Internationalen Steuerrecht, C.H. Beck, München 1995

Mössner, Jörg Manfred, Zur Auslegung von Doppelbesteuerungsabkommen, in: Völkerrecht - Recht der internationalen Organisationen - Weltwirtschaftsrecht, Festschrift für Ignaz Seidl-Hohenveldern, Köln 1988

Müller, ECJ Case Relating to the Recapture of Cross Border Loss Incurred by a Foreign PE, European Tax Service, November 2008

Muller, J., Cadbury Schweppes Case: A Review, Tax Planning International European Union Focus 2004, 14 et seq.

Müller, J., The Interest & Royalty Directive, Tax Planning International European Union Focus, June 2005

Müller, J.H., *Cartesio* (Case C-210/06), Tax Planning International European Tax Service, March 06, 2009

Murphy, Genuine Tax Planning OK in Europe? A Review of two Recent ECJ Cases, Accountancy Irl. 2006, 76 et seq.

Musgrave, Peggy B., United States Taxation of Foreign Investment Income: Issues and Arguments , The Law School of Harvard University, Cambridge, MA 1969

Musgrave, Richard A. / Musgrave, Peggy B., Inter-Nation Equity, in: Bird, Richard M. / Head, John G. (eds.): Modern Fiscal Issues. Essays in Honor of Carl S. Shoup, University of Toronto Press, Toronto-Buffalo 1972, 63 et seq.

Musgrave, Richard A., Criteria For Foreign Tax Credit, in: Taxation and Operations Abroad, Russell Baker (ed.), Tax Institute Symposium, Princeton 1960

Mutén, Leif, Schweden: Hinzurechnung, DBA mit Marokko, USA und “Nordisches” zur Erbschaftsteuer, und Alkoholversand, Internationales Steuerrecht (IStR) 2007, Länderbericht, 4

Mutén, Leif, Sweden: Council for Advance Tax Rulings Upholds CFC Legislation, Tax Notes International 2005, 209 et seq.

Mutén, Leif, Sweden: Law Council Critical of Proposed CFC Legislation, Tax Notes international 2003, 1319 et seq.

Mutén, Leif, Sweden's CFC Rules Under Change, Tax Notes International 2003, 216 et seq.

Nanetti, Francesco, Italy's Controlled Foreign Companies Legislation, Bulletin for International Fiscal Documentation 2000, 281 et seq.

Nanetti, Francesco, The Proposed Italian CFC Rules in the Light of EU-Law, EC Tax Review 2000, 206 et seq.

News Analysis: France-Switzerland Treaty Overrides CFC Regime, French Tax Court Rules, Tax Notes International 2002, 143

NFTC Foreign Income Project: International Tax Policy for the 21st Century, Report and Analysis, prepared by the US National Foreign Trade Council, Washington, D.C., December 15, 2001

Nias, Peter / Purcell, Nicola, Taxation of Global Operations Conducted Through a Tax Haven Subsidiary, Tax Planning International Forum, Host Country United Kingdom, (December) 2004

Noguera, Lionel / Streichen, Alain, National Report Luxembourg, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 409 et seq.

Not, Nicolas, French CFC Rules Held Incompatible with OECD Model Tax Convention, Tax Planning International Review 2002, 3 et seq.

O'Conner, J., AG Opinion in Cadbury Schweppes Case, Irish Tax Review 2006, page 45

O'Connor, J., The Current Tax Environment: Impact for Irish Business, Tax Planning International Review 2006, 17 et seq.

O'Shea, Tom, Dividend Taxation Post-Manninen: Shifting Sands or Solid Foundations?, Tax Notes International 2007, 887 et seq.

O'Shea, Tom, Holböck: Austrian Dividend Tax Rules Found Compatible With the EC Treaty, Tax Notes International 2007, 1131 et seq.

O'Shea, Tom, The UK's CFC Rules and the Freedom of Establishment: Cadbury Schweppes PLC and its IFSC Subsidiaries - Tax Avoidance or Tax Mitigation?, EC Tax Review 2007, 13 et seq.

Obser, Ralph, Kein Abzug von Betriebsstättenverlusten aus einem Drittstaat, Anmerkung zum BFH-Beschluss, Deutsches Steuerrecht (DStR) 2008, 1086 et seq.

OECD, Controlled Foreign Company Legislation, Studies in Taxation of Foreign Source Income, OECD, Paris 1996

OECD, Double Taxation Conventions and the Use of Base Companies, International Tax Avoidance and Evasion - Four Related Studies, Issues in International Taxation, OECD, Paris 1987

OECD, Double Taxation Conventions and the Use of Conduit Companies, International Tax Avoidance and Evasion - Four Related Studies, Issues in International Taxation, OECD, Paris 1987

OECD, Global Forum on Taxation - A Process for Achieving a Global Level Playing Field, Berlin, 3-4 June 2004, OECD, Paris 2004

OECD, Harmful Tax Competition - An Emerging Global Issue, OECD, Paris 1998

OECD, Model Tax Convention on Income and on Capital, Condensed Version, OECD, Paris 1992-2010

OECD, Progress Towards a Level Playing Field: Outcomes of the Global Forum on Taxation, Melbourne, 15-16 November 2005, OECD, Paris 2005

OECD, Tax Co-operation: Towards a Level Playing Field, 2006 Assessment by the Global Forum on Taxation, OECD, Paris 2006

OECD, The Application of the OECD Model Tax Convention to Partnerships, Issues in International Taxation, OECD, Paris 1999

OECD, The OECD's Project on Harmful Tax Practices - A Briefing Note for Journalists, OECD, Paris 2004

OECD, The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries, OECD, Paris 2006

OECD, The OECD's Project on Harmful Tax Practices: The 2001 Progress Report, OECD, Paris 2001

OECD, The OECD's Project on Harmful Tax Practices: The 2004 Progress Report, OECD, Paris 2004

OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, Paris 1995

Olléon, L., Article 209 B et conventions fiscales internationales: après les ténèbres, la lumière, Revue de jurisprudence fiscale 2002, 755 et seq.

Opinion Statement of the CFE ECJ Task Force on ECJ, *Columbus Container Services BVBA & Co v. Finanzamt Bielefeld-Innenstadt*, 6 December 2007, C-298/05 - April 2008, European Taxation 2008, 541 et seq.

Ottosen, Arne Mollin / Hansen, Lars Cort, Amendments to Denmark's Holding Company, CFC and Captive Insurance Company Regimes, Bulletin for International Fiscal Documentation 2001, 361 et seq.

Oyj Abp Case, Supreme Administrative Court Helsinki, KHO 2002/596 (26), dated March 20, 2002, International Tax Law Reports (ITLR), Volume 4, 2002, 1009 et seq.

Pacelli, Federico, The Application of Italian CFC Rules to Maltese Subsidiaries, Tax Notes International 2006, 153 et seq.

Pache, Sven, Die Urteile des BFH und des BGH vom 29.01.2003 als erste Reaktion auf die Überseering-Entscheidung des EuGH, Internationales Steuerrecht (IStR) 2003, 808 et seq.

Pahapill, H., Estonia: Finnish CFC Regime Not a Threat, Officials Say, Tax Notes International 2003, 1015 et seq.

Pals, Carsten / Becker-Christensen, Anne, Denmark Amends Taxation of Investment Funds, Tax Notes International 2005, 1061 et seq.

Panayi, Christiana, The Fundamental Freedoms and Third Countries: Recent Perspectives, European Taxation 2008, 571 et seq.

Panayi, Christiana, The Protection of Third-Country Rights in Recent EC Case Law, Tax Notes International 2007, 659 et seq.

Pedersen, Bente Moll, Denmark: Controlled Foreign Company Legislation, European Taxation 1995, 315 et seq.

Pedersen, Bente Moll, New Tax Rules in Denmark – CFC Taxation and Countermeasures Against Private Equity Funds, Bulletin for International Taxation 2007, 489 et seq.

Pedersen, Bente Moll, The Holding Company Regime in Denmark, Bulletin for International Fiscal Documentation 2000, 30 et seq.

Peracin, Gianfranco / De Luca, Alberto, Applying CFC Rules to 'Affiliates': Critical Elements for Consideration, Intertax 2008, 18 et seq.

Perin, Luigi, Italy Enacts Major Changes in International Taxation With the 2000 Tax Bill, Tax Notes International 2000, 2345 et seq.

Perin, Luigi, Italy: Italian Ministry of Finance Explains Controlled Foreign Company Rules, Tax Notes International 2001, 617 et seq.

Peroni, Robert J. / Clifton Fleming Jr. / Stephen E. Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 S.M.U. Law Rev. 455 (1999), 457 et seq.

Persoff, Mark, HMRC Revised Draft Guidance on Controlled Foreign Companies Rules, EC Tax Review 2008, 96

Pihlgren, Carl, A Break With Tradition, International Tax Review 2007, 62-63

Pihlgren, Carl, New Proposed CFC Legislation, International Tax Review, (September) 2007

Pistone, Pasquale, European Tax Law: *Quo Vadis*? in Luc Hinnekens and Philippe Hinnekens (eds.), A Vision of Taxes Within and Outside European Borders: Festschrift in Honour of Prof. Dr. Frans Vanistendael, Kluwer Law International 2008, 713 et seq.

Pistone, Pasquale, The Impact of Commuity Law on Tax Treaties: Issues and Solutions, EUCOTAX Series on European Taxation, Volume 4, Kluwer Law International, London 2002

Pistone, Pasquale, Ups and Downs in the Case Law of the European Court of Justice and the Swinging Pendulum of Direct Taxation, Intertax 2008, 146 et seq.

Plückebaum, Konrad / Malitzky, Heinz, Umsatzsteuergesetz, Heymanns, Köln 1998

Polivanova-Rosenauer, Tatjana / Toifl, Gerald, Besteuerung ausländischer Kapitalerträge und jüngste Rechtsprechung des EuGH, Steuer und Wirtschaft International (SWI) 2004, 228 et seq.

Portner, Rosemarie, Validity of CFC Rules in a Changing World: A German Perspective, Tax Notes International 2002, 1679 et seq.

Pouletty, Mathieu, Consequences Arising from the Decision on French CFC Rules, Tax Planning International European Union Focus 2002

Pouletty, Mathieu, French CFC Rules, Tax Planning International Focus 2002

Prats, Francisco Alfredo Garcia, National Report Spain, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 803 et seq.

Prebble Zoe / Prebble John, Comparing the General Anti-Avoidance Rule of Income Tax Law with the Civil Law Doctrine of Abuse of Law, Bulletin for International Taxation 2008, 151 et seq.

Prééminence des stipulations conventionnelles sur l'article 209 B du CGI, Revue de droit fiscal 2003, 586-587

PricewaterhouseCoopers, Corporate Taxes 2004-2005: Worldwide Summaries, John Wiley & Sons, Hoboken 2004

PricewaterhouseCoopers, Danish Parliament Approves Corporate Tax Incentives, Tax Analysts Tax Document Service 2002, Doc. 2002-12665

PricewaterhouseCoopers, Individual Taxes 2002-2003: Worldwide Summaries, John Wiley & Sons, Hoboken 2002

PricewaterhouseCoopers, Swedish Capital Gains, CFC Rule Changes Still in the Works, Tax Notes International 2002, 839 et seq.

PricewaterhouseCoopers, Swedish Capital Gains, CFC Rule Changes Still in the Works, Tax Analysts Tax Document Service 2002, Doc 2002-3867

Prokisch, Rainer, Fragen der Auslegung von Doppelbesteuerungsabkommen, Steuer und Wirtschaft International (SWI) 1994, 52 et seq.

Pyszka, Tillmann / Brauer, Michael, Ausländische Personengesellschaften im Unternehmenssteuerrecht: Outbound-Gestaltungen, Umwandlungen, Hinzurechnungsbesteuerung, Verlag Neue Wirtschafts-Briefe, Herne / Berlin 2004

Queiroli, Gianluca, A Comparison of Italian and U.S. CFC Legislation, Tax Notes International 2003, 1265 et seq.

Rainer, Anno / Müller, Stefan, Hinzurechnungsbesteuerung nach dem AStG, Remarks to the German Administrative Circular, Internationales Steuerrecht (IStR) 2007, 151 et seq.

Rainer, Anno / Roels, Jan / Thömmes, Otmar / Tomsett, Eric / Weening, Gerben / van der Hurk, Hans, ECJ Restricts Scope of CFC Legislation, Intertax 2006, 636 et seq.

Rainer, Anno, Columbus Container: Belgisches Koordinierungszentrum und AStG, Internationales Steuerrecht (IStR) 2008, 63 et seq.

Rainer, Anno, ECJ Restricts Scope of CFC Legislation, Intertax 2006, 636 et seq.

Rättig Horst / Protzen, Peer Daniel, Holdingbesteuerung nach derzeit geltendem und kommendem Außensteuergesetz, Internationales Steuerrecht (IStR) 2000, 548 et seq.

Rättig, Horst / Protzen, Peer Daniel, Das BMF-Schreiben vom 14.5.2004 – IV B 4 – S 1340 11/04 – (Grundsätze zur Anwendung des Außensteuergesetzes): Analyse und Kritik der wesentlichen Anordnungen im Bereich der Hinzurechnungsbesteuerung der Par. 7 bis 14 AStG, Internationales Steuerrecht (IStR) 2004, 625 et seq.

Rau, Günter / Dürrwächter, Erich, Umsatzsteuer Kommentar (loose leaf, July 2004), O. Schmidt, Köln 2004

Raventós, Stella, Spain: CFC Provisions Introduced, European Taxation 1995, 164 et seq.

Redpath Georgia / Pearse, Jacqui, The Excluded Countries Regulations, British Tax Review 1999, 81 et seq.

Rehm, Helmut / Nagler, Jürgen Anmerkungen zum nachstehenden EuGH-Urteil "Burda" S. 515, Internationales Steuerrecht (IStR) 2008, 511 et seq.

Rehm, Helmut / Nagler, Jürgen, Ist Par. 8a KStG a.F. weltweit nicht mehr anwendbar?: Folgen des Lasertec-Beschlusses des FG Baden-Württemberg vom 14.10.2004, Internationales Steuerrecht (IStR) 2005, 261 et seq.

Rehm, Helmut / Nagler, Jürgen, Neues von der grenzüberschreitenden Verlustverrechnung!, Internationales Steuerrecht (IStR) 2008, 129 et seq.

Rehm, Helmut/ Nagler, Jürgen, Verbietet die Kapitalverkehrsfreiheit nach 1993 eingeführte Ausländergleichbehandlung?, Internationales Steuerrecht (IStR) 2006, 859 et seq.

Reiser, Hagen / Brodersen, Jörg, Hinzurechnungsbesteuerung des AStG - Einführung einschließlich Analyse des EuGH-Urteils Cadbury Schweppes, Internationale Wirtschafts-Briefe (IWB) 2007, Fach 2, 9333 et seq.

Reuters, S&P Downgrades Greece Rating, Says May Cut Again, March 29, 2011

Richman, Peggy B., Taxation of Foreign Investment Income, An Economic Analysis, Baltimore, 1963

Richter, Dirk, Conseil d'Etat bestätigt Vorrang des DBA-Rechts von nationaler Hinzurechnungsbesteuerung, Internationales Steuerrecht (IStR) 2002, 653 et seq.

Richter, Dirk, Neueste Entwicklungen der französischen Rechtsprechung zum Außensteuerrecht bei DBA-Staaten, Internationales Steuerrecht (IStR) 2002, 231 et seq.

Risdale, Michael, Abuse of Rights, Fiscal Neutrality and VAT, EC Tax Review 2005, 82 et seq.

Rix, Jacob, National Report Denmark, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 139 et seq.

Röcklinger, Katrin, New Proposal for Extended CFC Legislation in Sweden, Tax Planning International Review 2003, 18 et seq.

Rödder Thomas / Schönfeld, Jens, Mündliche Verhandlung vor dem EuGH in der Rechtssache "Cadbury Schweppes": Wird sich der Missbrauchsbegriff des EuGH verändern?, Internationales Steuerrecht (IStR) 2006, 49 et seq.

Ronfeldt, Thomas / Vinther, Nikolaj / Werlauff, Erik, CFC Rules Go Up in Smoke - With Retroactive Effect, Intertax 2007, 45 et seq.

Rontani, Franqois / Charriau, Jean-Yves, French Tax Authorities Comment on Revised CFC Regime, Tax Notes International 1998, 1560 et seq.

Roser, Frank, Erforderliche Änderungen der Hinzurechnungsbesteuerung, Internationales Steuerrecht (IStR) 2000, 78 et seq.

Ross, The United Kingdom: Living With Anti-Tax Haven Legislation: Three Years of U.K. Experience, Bulleting for International Fiscal Documentation 1987, 263 et seq.

Rossi, Alessandro Adelchi, Italy: CFC Rules Don’t Apply to Affiliate, Revenue Agency Says, Tax Notes International 2005, 958

Rossi, Alessandro Adelchi, Overview of the Italian Tax System for U.S. Investors, Tax Notes International 2001, 371 et seq.

Rossi, Marco, Italy Introduces Corporate Tax Residency, Anti-Inversion Rules, Tax Notes International 2006, 699 et seq.

Rossi, Ruling on the Application of the Italian CFC Rules to a Maltese International Trading Company, European Taxation 2006, 131 et seq.

Rotondaro, Carmine, The Pavarotti Case: Decisions of the Tax Court of First Instance of Modena of 9 February 1999 and the Tax Court of Second Instance of Bologna of 27 March 2000, European Taxation 2000, 385 et seq.

Rousselle, Olivier / Liebmann, Howard M., The Doctrine of the Abuse of Community Law: The Sword of Damocles Hanging over the Head of EC Corporate Tax Law?, European Taxation 2006, 559 et seq.

Royou, P. / Hoo, M-P., France: Statement of Practice on CFC Rules of 17 April 1998, European Taxation 1998, 354 et seq.

Ruby, Douglas A., The Risk and Term Structure of Interest Rates, 2003, http://www.digitaleconomist.com/int_4020.html

Ruiz Almendral, Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?, Intertax 2005, 562 et seq.

Rupal, Yash / Todd, Neal, EU Court Opens Group Opportunities, International Tax Review 1999, 46 et seq.

Russo, Antonio / Busetto, Domenico, Italy: Proposal for the Introduction of CFC Legislation, Tax Planning International Review 1999, 8 et seq.

Russo, Raffaele: Tax Authorities’ Ruling on CFC Defines the Concept of “Income Produced Abroad”, European Taxation 1994, 379 et seq.

Rust, Alexander, National Report Germany, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 255 et seq.

Rytöhonka, Risto, Belgian coordination centre deemed by Finnish Court to be a CFC, Tax News Service (TNS), 33/2002, July 11, 2002

Rytöhonka, Risto, Finland: Belgium and the Netherlands Removed from “White List”, Tax News Service (TNS) 1998, 56

Rytöhonka, Risto, Finland: International Tax Law Reform, European Taxation 1995, 64 et seq.

Rytöhonka, Risto, Finland: New Tax Legislation, Tax News Service (TNS) 1996, 54 et seq.

Rytöhonka, Risto, Finland: Reform of International Tax Laws Contemplated, Tax News Service (TNS) 1994, 379 et seq.

Sammarco, M. / Domingo Pérez, G., Business Tax Planning Under Spain’s Holding Company Regime, Tax Notes International 2005, 47 et seq.

Sams, Jim / Patel, Sara, A Dash for the Exit?, The Tax Journal 2006, 17 et seq.

Sanden, B. Kenneth, Taxing Foreign Source Income: A Businessman’s View, New York Tax Foundation, New York 1977

Sandler, Daniel, Tax Treaties and Controlled Foreign Company Legislation - Pushing the Boundaries, 2. Edition, Kluwer Law International, The Hague / London / Boston 1998

Sandler, Daniel, Tax Treaties and Controlled Foreign Company Legislation, British Tax Review 1998, 52 et seq.

Saß, Gert, Zum Schutz von Kapitalbewegungen in der EU gegen steuerliche Diskriminierung, Finanz-Rundschau (FR) 2000, 1270 et seq.

Scarioni, Paolo / Muni, Simone, The New Italian CFC Rules: EU Holding Companies Challenge the ‘Artificial Arrangement’ Assessment, Intertax 2010, 527 et seq.

Schaumburg, Harald, Internationales Steuerrecht - Außensteuerrecht, Doppelbesteuerungsrecht, O. Schmidt, Köln 1998

Scherer, Thomas B., Doppelbesteuerung und Europäisches Gemeinschaftsrecht: Auswirkungen des Gemeinschaftsrechts auf die Anwendung der Doppelbesteuerungsabkommen und des Außensteuerrechts, C.H. Beck, München 1995

Schindel, Angel / Atchabahian, Adolfo, Source and Residence: New Configuration of their Principles, General Report, Cahiers de Droit Fiscal International, IFA Vol. 90a, Sdu Fiscale & Financiele Uitgevers, Amersfoort 2005, page 21 et seq.

Schmidtmann, Dirk, Hinzurechnungsbesteuerung bei internationalen Umwandlungen – Neuregelungen durch das SEStG, Internationales Steuerrecht (IStR) 2007, 229 et seq.

Schnitger, Arne, Die Kapitalverkehrsfreiheit in Verhältnis zu Drittstaaten: Vorabentscheidungsersuchen in den Rs. van Hilten, Fidium Finanz AG und Lasertec, Internationales Steuerrecht (IStR) 2005, 493 et seq.

Schnitger, Arne, German CFC Legislation Pending before the European Court of Justice - Abuse of the Law and Revival of the Most-Favoured-Nation-Clause?, EC Tax Review 2006, 151 et seq.

Schnitger, Arne, Grenzüberschreitende Körperschaftsteueranrechnung und Neuausrichtung der Kohärenz nach dem EuGH-Urteil in der Rs. Manninen, Finanz-Rundschau (FR) 2004, 1357 et seq.

Schnitger, Arne, Par. 20 Abs. 2 und 3 AStG a.F. vor dem EuGH - Meistbegünstigung “Reloaded”?, Finanz-Rundschau (FR) 2005, 1079 et seq.

Schön, Wolfgang, CFC Legislation and European Community Law, British Tax Review 2001, 250 et seq.

Schön, Wolfgang, Der Kapitalverkehr mit Drittstaaten und das internationale Steuerrecht, in: Gocke, Rudolf / Gosch, Dietmar / Lang; Michael (eds.), Körperschaftsteuer-Internationales Steuerrecht-Doppelbesteuerung, Festschrift für F. Wassermeyer, C.H. Beck, München 2005, 499 et seq.

Schön, Wolfgang, Europäische Kapitalverkehrsfreiheit und nationales Steuerrecht, in: Schön, Wolfgang (ed.): Gedächtnisschrift für Brigitte Knobbe-Keuk, O. Schmidt, Köln 1997, 743 et seq.

Schön, Wolfgang, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht, Der Betrieb (DB) 2001, 940 et seq.

Schönfeld Jens / Lieber Bettina, Swedish CFC-Rules under Scrutiny of EC Law: Harmful Tax Competition and the Free Movement of Capital in Relation to Third Countries, Intertax 2006, 96 et seq.

Schönfeld, Jens / Lieber, Bettina, Nun auch schwedische Hinzurechnungsbesteuerung auf dem Prüfstand des EG-Rechts, Finanz-Rundschau (FR) 2005, 927 et seq.

Schönfeld, Jens, Dänemark: Ausdehnung der Hinzurechnungsbesteuerung auf das Inland?, Internationales Steuerrecht (IStR) 2007, Länderbericht, 1-2

Schönfeld, Jens, Der neue Artikel 1 DBA-USA – Hinzurechnungsbesteuerung und abkommensrechtliche Behandlung von Einkünften steuerlich transparenter Rechtsträger, Internationales Steuerrecht (IStR) 2007, 274 et seq.

Schönfeld, Jens, Die Fortbestandsgarantie des Art. 57 Abs. 1 EG im Steuerrecht: Anmerkung zu FG Hamburg vom 9.3.2004, VI 279/01, EFG, 2004, 1573, Internationales Steuerrecht (IStR) 2005, 410 et seq.

Schönfeld, Jens, Hinzurechnungsbesteuerung und Europäisches Gemeinschaftsrecht, O. Schmidt, Köln 2005

Schönfeld, Jens, Hinzurechnungsbesteuerung zwischen Steuerwettbewerb und Europäischen Grundfreiheiten, Steuer und Wirtschaft 2005, 158 et seq.

Schönfeld, Jens, Reaktion der britischen Regierung auf "Cadbury Schweppes": Geplante Änderungen der britischen CFC-Rules und deren Vereinbarkeit mit EG-rechtlichen Vorgaben, Internationales Steuerrecht (IStR) 2007, 199 et seq.

Schönfeld, Jens, The Cadbury Schweppes Case: Are the Days of the United Kingdom's CFC Legislation Numbered, European Taxation 2004, 441 et seq.

Schraufl, Martin, Dies Auswirkungen der Konkurrenz zwischen Niederlassungs- und Kapitalverkehrsfreiheit auf Drittstaatensachverhalte im Steuerrecht: Zugleich Anmerkungen zum EuGH-Beschluss vom 10.5.2007, Recht der Internationalen Wirtschaft (RIW) 2007, 632 et seq.

Schuch, Josef, Pending Cases Filed by Austrian Courts: The Lenz Case, in: Direct Taxation: Recent ECJ Developments, Direct Taxation, Michael Lang (ed.), Kluwer Law International, London 2003, 137 et seq.

Schumacher, Andreas, National Report Germany, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 523 et seq.

Schwarz, Jonathan S., Abuse and EU Tax Law, Bulletin for International Taxation 2008, 289 et seq.

Schwarz, Jonathan S., Controlled Foreign Companies and E-Commerce: a UK Perspective, Tax Planning International E Commerce 2000, 27 et seq.

Schwarz, Jonathan S., Controlled Foreign Companies and Tax Treaties, Bulletin for International Fiscal Documentation 1997, 553 et seq.

Secular, Les, United Kingdom: Proposed Changes to CFC Legislation, European Taxation, 1998, 100 et seq.

Sedemund, Jan, Der EuGH verwirft eine wirtschaftliche Betrachtungsweise für die Anwendung der Mutter-Tochterrichtlinie, Betriebs-Berater (BB) 2008, 1830-1831

Sedemund, Jan, Die mittelbare Wirkung der Grundfreiheiten für in Drittstaaten ansässige Unternehmen nach den EuGH-Urteilen Fidium Finanz AG und Cadbury Schweppes: Zugleich eine Anmerkung zum Vorlagebeschluss des BFH vom 22.8.2006 - IR 116/04, Betriebs-Berater (BB) 2006, 2781 et seq.

Sedemund, Jan, Voraussetzungen für die Körperschaftsteueranrechnung nach dem EuGH-Urteil Meilicke, Internationales Steuerrecht (IStR) 2007, 245 et seq.

Sedlaczek, Michael, Capital and Payments: The Prohibition of Discrimination and Restrictions, European Taxation 2000, 14 et seq.

Sedlaczek, Michael, Der Begriff der Diskriminierung und der Beschränkung - die Kapitalverkehrsfreiheit als konvergente Grundfreiheit des EG-Vertrages, in: Lechner, Eduard / Staringer, Claus / Tumpel, Michael (eds.): Kapitalverkehrsfreiheit und Steuerrecht: Eine Analyse des österreichischen Steuerrechts vor dem Hintergrund der Kapitalverkehrsfreiheit des EG-Rechts, Linde Verlag, Vienna 2000, 27 et seq.

Seer, Roman, The Jurisprudence of the European Court of Justice: Limitation of the Legal Consequences?, European Taxation 2006, 470 et seq.

Seidel, Martin, Recht und Verfassung des Kapitalmarktes als Grundlage der Währungsunion, in: Randelzhofer, Albrecht / Scholz, Rupert / Wilke, Dieter (eds.), Gedächtnisschrift für Eberhard Grabitz, München 1995, 763 et seq.

Serbini, Stefano, The New Italian Legislation on Controlled Foreign Companies, Intertax 2001, 86 et seq.

Servigny de, Arnaud / Renault, Oliver, The Standard & Poor's Guide to Measuring and Managing Credit Risk, McGraw-Hill, New York 2004

Shelton, Ned, Denmark: New Tax Law for Holding Companies, Tax Planning International Review 2002, 22

Sheppard, Lee A., Cadbury Schweppes: The ECJ versus Tax Administration, Tax Notes International 2006, 452 et seq.

Sheppard, Lee A., The Year in Review: European Union, Tax Notes International 2006, 1034 et seq.

Sieker, Klaus, Steuervergünstigungsabbaugesetz: vorgesehene Verschärfungen der Rechtsfolgen der Hinzurechnungsbesteuerung, Internationales Steuerrecht (IStR) 2003, 78 et seq.

Simader, Karin, Withholding Taxes and the Effectiveness of Fiscal Supervision and Tax Collection, European Taxation 2010, 115 et seq.

Simmons & Simmons, EU Tax Update, January 2005, 3

Simpson, G.J. / Venables, R., Bricom Again; The Bricom Decision, The Offshore Tax Planning Review 1997, 97 et seq.

Simpson, Philip, Cadbury Schweppes plc v Commissioners of Inland Revenue: the EC Sets Strict Test for CFC Legislation, British Tax Review 2006, 677 et seq.

Smit, Daniel, Capital Movements and Third Countries: The Significance of the Standstill-Clause ex-Article 57 (1) of the EC Treaty in the Field of Direct Taxation, EC Tax Review 2006, 203 et seq.

Smit, Daniel, The Relationship between the Free Movement of Capital and the other EC Treaty Freedoms in Third Country Relationships in the Field of Direct Taxation: A Question of Exclusivity, Parallelism or Causality?, EC Tax Review 2007, 252 et seq.

Smith, N., CFC Rules in the EU, IT Rep. 2006, 6 et seq.

Smith, N., Recent Issues in Danish CFC Rules, Tax Planning International: European Union Focus 2006, 3 et seq.

Smith, N., The Revised Tax Law Proposal in Denmark, Tax Planning International: European Tax Service 2007, 11 et seq.

Smyth, David / Manton, Janelle, The Cadury Schweppes Case: A Win for Taxpayers?, Irish Tax Review 2006, 96 et seq.

Soares da Silva, David Roberto R., Court Ruling Threatens Application of Two Tax Treaties, Tax Notes International, July 17, 2006, 206

Société Schneider Electric, Conseil D'Etat Paris, Appeal no. 232 278, dated June 28, 2002, International Tax Law Reports (ITLR), Volume 4, 2002, 1077 et seq.

Sorensen, Michael, National Report Denmark, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 457 et seq.

Sousa da Camara de, Francisco / Ayala, Bernardo, National Report Portugal, in: Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends, Cahiers de Droit Fiscal International, IFA Vol. 86b, Kluwer Law International, The Hague 2001, 767 et seq.

Sousa da Camara de, Francisco / Ayala, Bernardo, Portugal: CFC Taxation, European Taxation 1996, 21 et seq.

Sousa da Camara de, Francisco / Nuncio, Portugal's 2002 Budget Bill Revises Capital Gains Tax Regime, Tax Analysts Tax Document Service 2001, Doc. 2001-28988

Spierts, Etienne M.S., Steueränderungen in den Niederlanden, Internationale Wirtschafts-Briefe (IWB) 2007, Fach 5, Gruppe 2, 25 et seq.

Spreafico, Taxation of Global Operations Conducted Through a Tax Haven Subsidiary, Tax Planning International Forum, Host Country Italy, (December) 2004

Stahl, Kristina, Free Movement of Capital between Member States and Third Countries, EC Tax Review 2004, 47 et seq.

Stangl, Christian, Der Begriff der steuerlichen Kohärenz nach den Urteilen *Baars* und *Verkooijen*, Steuer und Wirtschaft International (SWI) 2000, 463 et seq.

Staringer, Claus, Pending Cases Filed by Austrian Courts: The *Holböck* Case, in: ECJ - Recent Developments in Direct Taxation, EUCOTAX Series on European Taxation, Linde Verlag, Vienna 2006, 9 et seq.

Steenholdt, Soren / Josephsen, Niels, Denmark: The New Holding Company Regime, European Taxation 1999, 147 et seq.

Stefaner, Markus Christoph, Geht die Europäische Kommission gegen CFC-Gesetzgebung vor?, Steuer und Wirtschaft International (SWI) 2002, 415 et seq.

Stein von, Lorenz, Lehrbuch der Finanzwissenschaft, 5. Auflage, F.A. Brockhaus, Leipzig 1885-86

Steinhoff, Finland: Changes to International Tax Rules, Intertax 1995, 166

Steinhoff, Sweden: New Tax Measures Proposed, Intertax 1995, 171

Stevens, Ton, Blumen aus Holland? - Auswirkungen der Leur-Bloem-Entscheidung auf das niederländische Umwandlungssteuerrecht, Internationales Steuerrecht (IStR) 1998, 201 et seq.

Stok van der, Eelko / Thomson, Andrew, Temporal Limitations to Tax Judgements of the European Court of Justice, Intertax 2006, 552 et seq.

Sullivan, Matthew / Wallner, Robert / Wübbelsmann, Stephan, Die deutsche Hinzurechnungsbesteuerung auf dem europäischen Prüfstand, Internationales Steuerrecht (IStR) 2003, 6 et seq.

Sundgren, Peter, Controlled Foreign Company (CFC) Legislation in Sweden, Bulletin for International Fiscal Documentation 1990, 400 et seq.

Sundgren, Peter, Sweden: Tax Reform and Other Recent Developments, European Taxation 1990, 58 et seq.

Sundgren, Peter, Swedish CFC Taxation and the 'Business Purpose' Concept, Tax Notes International 2008, 133 et seq.

Tahon, Marc / Bogaerts, Raf, Belgium: Amendments to the Participation Exemption Regime, Tax Planning International Review 2002, 15 et seq.

Tax Treaty with Switzerland Overrides French CFC Legislation, Paris Appeals Court Rules, Tax Notes International 2001, 1377

Taylor, D. / Sykes, L., Controlled Foreign Companies and Foreign Profits, British Tax Review 2007, 609 et seq.

Taylor, Rodney, Further Changes to Double Taxation Relief (DTR) and Controlled Foreign Company (CFC) Measures, Tax Planning International Review 2000, 38 et seq.

Taylor, Rodney, New Draft CFC Legislation in the United Kingdom, Tax Planning International Review 1998, 3 et seq.

Teixeira de Abreu, Miguel, Controlled Foreign Corporation Legislation in Portugal, Tax Planning International Review 1997, 17 et seq.

Terra, Ben J. M. / Wattel, Peter J., European Tax Law, 2. Edition, Kluwer, Deventer 1997

Terra, Ben J. M. / Kajus, Julie, A Guide to the European VAT Directives, IBFD, Amsterdam 2004

Tetzlaff, Gunnar / Schallock, Alexander Abzug von Verlusten ausländischer Betriebsstätten in Deutschland möglich?, Internationale Wirtschafts-Briefe (IWB) 2006, Fach 3, Gruppe 2, 1325 et seq.

The Guardian, Financial Markets Tumble After Fitch Downgrades Greece's Credit Rating, December 8, 2009

The Washington Post, Standard & Poor's Financial Storm Warning, April 19, 2011

Thiel van, S., Deductibility of Input Tax: Concept of Taxable Person and Taxable Supply under the Sixth VAT Directive, International VAT Monitor, 1991, 18 et seq.

Thiel van, Servaas / Vascega, Marius, *X Holding*: Why Ulysses Should Stop Listening to the Siren, European Taxation 2010, 334 et seq.

Thiel van, Servaas, Daily Mail Case: Tax Planning and the European Right of Establishment: A Setback, European Taxation 1988, 357 et seq.

Thill, Pierre-Sébastien / Milhac, Edouard, French CFC Regime Examined, Tax Notes International 1997, 779 et seq.

Thömmes, Otmar / Kowallik, Andreas, ECJ Decided on German Taxation of Leasing, Tax Notes International 2000, 865 et seq.

Thömmes, Otmar / Nakhai, Katja, Berufung auf die Kapitalverkehrsfreiheit für Drittstaatunternehmen, Internationale Wirtschafts-Briefe (IWB) 2006, Fach 11A, 1103 et seq.

Thömmes, Otmar / Nakhai, Katja, Ende der Hinzurechnungbesteuerung in Europa, Internationale Wirtschafts-Briefe (IWB) 2006, Fach 11A, 1065 et seq.

Thömmes, Otmar, Beschränkung der Niederlassungsfreiheit: EuGH, Urt. v. 5.11.2002 - Rs. C-208/00 Überseering BV gegen Nordic Construction Company

Baumanagement GmbH (NCC), Internationale Wirtschafts-Briefe (IWB), Fach 11A, 623 et seq.

Thömmes, Otmar, Besinnung auf das Territorialitätsprinzip, Internationale Wirtschafts-Briefe (IWB) 2006, Fach 11A, 1071 et seq.

Thömmes, Otmar, Das EuGH-Urteil in der Rechtssache Eurowings - nun ist der Gesetzgeber gefordert, Internationales Steuerrecht (IStR) 1999, 753

Thömmes, Otmar, Kein Anspruch auf grenzüberschreitende Übertragung von Gewinnen innerhalb eines europäischen Konzerns, Internationale Wirtschafts-Briefe (IWB) 2007, Fach 11A, 1151 et seq.

Thömmes, Otmar, Kein grundsätzlicher Verstoß gegen Niederlassungsfreiheit: Gewinnkorrektur bei Vorteilsgewährung an verbundene Unternehmen im EU-Ausland, Internationale Wirtschafts-Briefe (IWB) 2010, 107 et seq.

Thömmes, Otmar, Klagemöglichkeit ausländischer juristischer Personen vor deutschen Gerichten, Internationale Wirtschafts-Briefe (IWB) 2002, Fach 11A, 575 et seq.

Thömmes, Otmar, Übergang zur Hinzurechnungsmethode bei Betriebsstätten EG-rechtskonform, Internationale Wirtschafts-Briefe (IWB) 2008, Fach 11A, 1169 et seq.

Thömmes, Otmar, Vereinbarkeit der britischen Hinzurechnungsbesteuerung mit Gemeinschaftsrecht, Internationale Wirtschafts-Briefe (IWB) 2006, Fach 11A, 1019 et seq.

Thömmes, Otmar, Verpflichtung zur Anrechnung ausländischer Körperschaftsteuer - keine zeitliche Beschränkung der Urteilswirkungen, Internationale Wirtschafts-Briefe (IWB), 2007, Fach 11A, 1131 et seq.

Tillmanns, Wolfhard, Steueränderungen Frankreich 2004/2005, Internationale Wirtschafts-Briefe (IWB), Fach 5, Gruppe 2, 1417 et seq.

Tippelhofer, Martina / Lohmann, Adrian, Niederlassungsfreiheit vs. Kapitalverkehrsfreiheit: Analyse der jüngeren Rechtsprechung des EuGH zu den direkten Steuern, Zugleich Anmerkungen zum EuGH-Urteil in der Rechtssache *Burda* (C-284/06), Internationales Steuerrecht (IStR) 2008, 857 et seq.

Tognolo, Paolo, New Controlled Foreign Corporations (CFC) Rule in Italy, Tax Planning International Review 2001, 7 et seq.

Tognolo, Paolo, New Italian CFC Rules: Main Issues and Comments, Tax Planning International Review 2002, 19 et seq.

Tomsett, Eric, AG Rules on CFC Legislation in Cadbury Schweppes Case, Intertax 2006, 448-449

Tomsett, Eric, ECJ Rules UK CFC Legislation Contrary to EC Law, Intertax 2006, 575

Troiano, Paolo, Italian Controlled Foreign Company Legislation: Publication of the "Black List", Intertax 2002, 109 et seq.

Turner, G.,The Legitimacy of CFC Legislation within the Community, The EC Tax Journal 2007, 23 et seq.

U.K. Inland Revenue, U.K. Announces CFC Anti-Avoidance Legislation Aimed at Designer Tax Regimes, Tax Analysts Tax Document Service 1999, Doc 1999-32181

Ullah, Monuhar, National Report United Kingdom, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 605 et seq.

United Kingdom, *Vodafone* Loses UK Tax Appeal, European Tax Service, May 2009

United Kingdom: U.K. Tax Update: Is a Cow Also a Horse With Horns? - Special Commissioners Confirm Application of CFC Rules to Captive Insurers, Tax Notes International 2003, 847

Uustalu, Erki, Estonia: Estonia Introduces CFC Rules, Tax Notes International 2000, 727 et seq.

Uustalu, Erki, National Report Estonia, in: Lang, Michael / Aigner, Hans-Jörgen / Scheuerle, Ulrich / Stefaner, Markus, CFC Legislation, Tax Treaties and EC Law, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, The Hague / London / New York 2004, 173 et seq.

Valente, Piergiorgio / Magenta, Marco, Italy: New CFC Legislation, Intertax 2001, 52 et seq.

Vanistendael, Frans, Cohesion: The Phoenix Rises from his Ashes, EC Tax Review 2005, 208 et seq.

Vanistendael, Frans, Halifax and Cadbury Schweppes: One Single European Theory of Abuse in Tax Law?, EC Tax Review 2006, 192 et seq.

Vasco, Domingo Carbajo, Spain: New Corporate Income Tax Act, EC Tax Review 1996, 103 et seq.

Venables, Robert, Double Taxation Treaties: The Antidote to Anti-Avoidance Provisions?, The Offshore Tax Planning Review 1996, 151

Verdoner, L., The Coherence Principle under EC Tax Law, European Taxation 2009, 274 et seq.

Viegener, J., Hinzurechnungsbesteuerung und Doppelbesteuerungsabkommen in Frankreich, in: Körperschaftsteuer Internationales Steuerrecht Doppelbesteuerung: Festschrift für Franz Wassermeyer zum 65. Geburtstag, C.H. Beck, München 2005, 543 et seq.

Viherkenttä, Timo, Finland Enacts New Controlled Foreign Company Legislation, Tax Notes International 1995, 695 et seq.

Vinther, N. / Werlauff, E., Tax Motives Are Legal Motives - The Borderline between the Use and Abuse of the Freedom of Establishment with Reference to the *Cadbury Schweppes* Case, European Taxation 2006, 383 et seq.

Vogel, Klaus / Lehner, Moris, Doppelbesteuerungsabkommen der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen, Kommentar auf der Grundlage der Musterabkommen, 4. Auflage, C.H. Beck, München 2003

Vogel, Klaus / Prokisch, Rainer, Interpretation of Double Tax Conventions, General Report, Cahiers de Droit Fiscal International, IFA Vol. 78a, Kluwer Law International 1993, 55 et seq.

Vogel, Klaus, France's Conseil D'Etat: Tax Treaties Prevail Over CFC Rules, Bulletin for International Fiscal Documentation 2002, 498 et seq.

Vogel, Klaus, Grundfragen des internationalen Steuerrechts, O. Schmidt, Köln 1985

Vogel, Klaus, Klaus Vogel on Double Taxation Conventions, 3. Edition, Kluwer Law International, London 1997

Vogel, Klaus, Rechtfertigung der Steuern: eine vergessene Vorfrage, in: Der Staat 1986, 481 et seq.

Vogel, Klaus, Which Method Should the European Community Adopt for the Avoidance of Double Taxation?, Bulletin for International Fiscal Documentation 2002, 4 et seq.

Vogel, Klaus, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part I), Intertax 1988/8-9, 216 et seq.

Vogel, Klaus, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part II), Intertax 1988/10, 310 et seq.

Vogel, Klaus, Worldwide vs. Source Taxation of Income - A Review and Re-Evaluation of Arguments (Part III), Intertax 1988/11, 393 et seq.

Wagner, Siegfried, Die Zukunft des internationalen Steuerrechts nach dem Manninen-Urteil, Deutsche Steuer-Zeitung (DStZ) 2005, 325 et seq.

Waldens, Stefan / Sedemund, Jan, Steuern steuern durch Prinzipalstrukturen: Ist nach Cadbury Schweppes nunmehr fast alles möglich?, Internationales Steuerrecht (IStR) 2007, 450 et seq.

Wartenburger, Lucas, Die Bedeutung des Gemeinschaftsrechts für innergemeinschaftliche Steueroasen, Internationales Steuerrecht (IStR) 2001, 397 et seq.

Wassermeyer, Franz, Das Wirrwarr mit den Aktivitätsklauseln im deutschen Abkommensrecht, Internationales Steuerrecht (IStR) 2000, 65 et seq.

Wassermeyer, Franz, Die Anwendung der deutschen Hinzurechnungsbesteuerung auf Umwandlungen von ausländischen Tochter- und Enkelgesellschaften, in: Körperschaftsteuer Internationales Steuerrecht Doppelbesteuerung: Festschrift für Franz Wassermeyer zum 65. Geburtstag, C.H. Beck, München 2005, 571 et seq.

Wassermeyer, Franz, Die Vereinbarkeit der Hinzurechnungsbesteuerung nach dem Außensteuergesetz mit dem Grundgesetz und den Vorschriften der Doppelbesteuerungsabkommen (OECD-Musterabkommen), in: Jakobs, Horst Heinrich / Knobbe-Keuk, Brigitte / Picker, Eduard / Wilhelm, Jan (eds.), Festschrift für Werner Flume zum 70. Geburtstag, 12. September 1978, Band II, O. Schmidt, Köln 1978, 323 et seq.

Wathelet, Melchior, Free Movement of Capital, Tax Journal 2005, 4 et seq.

Weber, Dennis, A Closer Look at the General Anti-Abuse Clause in the Parent-Subsidiary Directive and the Merger Directive, EC Tax Review 1996, 63 et seq.

Weber, Dennis, ECJ 25 February 2010, C-337/08, *X Holding*, Highlights & Insights on European Taxation 1/2010, 64 et seq.

Weber, Dennis, ECJ concludes Netherlands Fiscal Investment Fund Regime incompatible with EC Law: *Orange European Smallcap Fund*, Tax Planning International European Tax Service, June 2008

Weber, Dennis, Exit Taxes on the Transfer of Seat and the Applicability of the Freedom of Establishment after Überseering, European Taxation 2003, 350 et seq.

Weber, Dennis, Fidium Finanz AG v Bundesanstalt für Finanzdienstleistungsaufsicht: The ECJ Gives the Wrong Answer About the Applicability of the Free Movement of Capital Between the EC Member States and Non-Member Countries, British Tax Review 2007, 670 et seq.

Weerth de, Jan, Grenzüberschreitende Körperschaftsteueranrechnung nach “Manninen”!, Deutsches Steuerrecht (DStR) 2004, 1992 et seq.

Weerth de, Jan, Zur rückwirkenden Anwendung von EuGH-Urteilen am Beispiel der “Manninen”-Entscheidung des EuGH, Der Betrieb (DB) 2005, 1407 et seq.

Weizman, Leif, Denmark: International Tax Reform of 1994-1995, Tax Notes International, 1995, 7 et seq.

Wellens, Andreas, Nichtabziehbare Betriebsausgaben bei Drittlandsdividenden - Kapitalverkehrsfreiheit contra Niederlassungsfreiheit, Deutsches Steuerrecht (DStR), 2007, 1852 et seq.

Werlauff, Erik / Vinther, Nicolaj, Tax Motives are Legal Motives - The Borderline between the Use and Abuse of the Freedom of Establishment with Reference to the Cadbury Schweppes Case, European Taxation 2006, 383 et seq.

Werlauff, Erik, The Consequences of the Centros Decision: Ends and Means in the Protection of Public Interests, European Taxation 2000, 542 et seq.

Wettum van, W. / Bevers, J. / Minnen van, R., The Netherlands: Corporate Income Tax Reform 2007, Tax Planning International Review 2006, 12 et seq.

Whitecross, Duncan / Pearse, Jacqui, Controlled Foreign Companies and Self Assessment, British Tax Review 1998, 9 et seq.

Whitecross, Duncan / Redpath, Georgia, Post-CTSA: Taking Stock of the Controlled Foreign Companies Legislation, Tax Planning International Review 2000, 14 et seq.

Whitehead, Simon, A Definite Resemblance, International Tax Review 2007, 43 et seq.

Whitehead, Simon, Practical Implications Arising from the European Court's Recent Decisions Concerning CFC Legislation and Dividend Taxation, EC Tax Review 2007, 176 et seq.

Whitehead, Simon, What's Your Motive?, Taxation 2006, 682 et seq.

Whitehouse, M.,The UK and Non-EU States: Fortress Europe?, The Tax Journal 2007, 21 et seq.

Wilkinson, Ross / Howells, Warren, Controlled Foreign Companies: Cadbury Gains Significant Upper Hand, The Tax Journal 2006, 17 et seq.

Willeme, Peter / Schutz, Godfried, Dutch Reforms can deliver for Investors, International Tax Review 2007, 28 et seq.

Williams, D., Do the CFC Rules Breach the EU Treaty?, Taxline 2004, 8 et seq.

Wimpissinger, Christian, Cross-Border Transfer of Losses, the ECJ does not agree with Advocate General Sharpston, EC Tax Review 2008, 173 et seq.

Wimpissinger, Christian, Der Fall Verkooijen und seine Auswirkungen, Steuer und Wirtschaft International (SWI) 2000, 313 et seq.

Wimpissinger, Christian, Gemeinschaftsrechtswidrigkeit der Hinzurechnungsbesteuerung ausländischer Betriebsstätteneinkünfte in Deutschland: Neue Erkenntnisse aus Cadbury Schweppes für Columbus Container?, Steuer und Wirtschaft International (SWI) 2006, 559 et seq.

Wisell, I. / Rohdin, B., Sweden: Some Aspects of International Taxation, European Taxation, 1991, 179 et seq.

Wisell, I., Sweden: Income Tax Changes for Companies, European Taxation 1994, 432 et seq.

Wittendorff, Jens, Danish Bill on International Taxation, Intertax 1995, 211 et seq.

Wittendorff, Jens, Denmark: CFC Rules Changes in the Works, Tax Notes International 2006, 104

Wittendorff, Jens, Denmark: Possible Corporate Tax Rate Cuts and Anti-Avoidance Measures, Tax Planning International Review, (February) 2007

Zalasinski, Adam, Some Basic Aspects of the Concept of Abuse in the Tax Case Law of the European Court of Justice, Intertax 2008, 156 et seq.

Zeuner, Jörg, Sind Unternehmensanleihen attraktiv?, News aus den Finanzmärkten, November 18, 2008

Zhou, Chunsheng, Default Correlation: An Analytical Result, Finance and Economics Discussion Series, Paper 1997-27, Federal Reserve Board of Governors, Washington D.C. 1997

Zoetmulder, Bartjan, R., Dutch 2007 Tax Reform “Working on Profit” Approved by Upper House, Tax Planning International European Union Focus, (December) 2006, 3-4